

Title Alert 2015-04

April 3, 2015

Insuring Mechanics' Lien Risk

Purpose: To memorialize the current standards for underwriting approval of title insurance policies that provide coverage for mechanics' liens. This communication supersedes all prior Title Alerts and communications issued by Penn Attorneys, a division of Ohio Bar Title Insurance Company (PA/OBT) regarding mechanics' liens.

Background: Under Pennsylvania law¹, contractors, subcontractors and suppliers (including subcontractors and suppliers of subcontractors), have the right, within six (6) months of completion of work, to file a mechanics' lien against the real estate for the payment of all debts due to them. In most situations, a filed mechanics' lien relates back to the date of visible commencement of work. Visible commencement can include land clearance, demolition, excavation and even delivery of materials. If there is any indication that work began prior to the recording of a mortgage, a later filed mechanics' lien will take priority over the lien of the mortgage, thereby creating "broken priority". Providing coverage against unfiled mechanics' liens to a lender is very risky when broken priority exists. Similar risk exists when insuring a purchaser of land on which a building was recently constructed before the expiration of the six (6) month lien filing period.

Standard: PA/OBT and its approved attorneys must apply the following rules to all Pennsylvania transactions.

Owner's Policies

- (1) **No Commencement of Construction:** If evidence is provided that no work has been or will be performed on, nor materials supplied to, the property within the six (6) month period immediately preceding the recording of the insured deed, an owner's policy may be issued to the purchaser without the general mechanics' lien exception². Such evidence may include a Seller's Affidavit, Mortgages/Owners Affidavit, Buyers & Sellers Closing Certification or Mortgages/Owners Closing Certification containing an averment to that effect. Here is a link to our Forms and Documents: <http://www.pennattorneys.com/documents/index.html>
- (2) **Commencement of Construction:** If work has been performed on, and/or materials supplied to, the property within the six (6) month period immediately preceding the recording of the insured deed, **special underwriting must be performed** in order to issue an owner's policy to the buyer without the general mechanics' lien exception. These types of transactions carry a greater mechanics' lien risk and must be underwritten accordingly. While the analysis is transaction specific, PA/OBT will require some or all of the following information to determine whether to give mechanics' lien coverage to an owner purchasing property on which construction has occurred within the past six (6) months:
 - list of subcontractors and suppliers who provided labor and/or materials to the project,
 - unconditional lien releases from the general contractor and subcontractors and suppliers for work performed or materials supplied,
 - and financial information (preferably audited) for the proposed indemnitor(s).
 - We will also require indemnity from a financially sound source.

¹ The Mechanics' Lien Law of 1963, 49 P.S. § 1101 et seq.

² "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."

Loan Policies

- (1) **Purchase Money Mortgage:** If the mortgage being insured meets the statutory definition of a purchase money mortgage as set forth in 42 Pa.C.S.A. §8141(1)³, a loan policy may be issued without the general mechanics' lien exception regardless of whether broken priority exists.

- (2) **No Broken Priority – Not a Construction Mortgage:** If evidence is provided that no broken priority exists and the insured mortgage is not a construction mortgage, a loan policy may be issued without the general mechanics' lien exception. Such evidence may include a Seller's Affidavit, Mortgagors/Owners Affidavit, Buyers & Sellers Closing Certification or Mortgagors/Owners Closing Certification containing an averment to that effect. Here is a link to our Forms and Documents: <http://www.pennattorneys.com/documents/index.html>

- (3) **No Broken Priority – Construction Mortgage:** If evidence is provided that no broken priority exists, and the insured mortgage is an open-end construction mortgage as defined by 42 Pa.C.S. §8143(f)⁴, a loan policy may be issued without the general mechanics' lien exception. Because the mere fact that we are insuring a construction mortgage indicates that construction is intended to be done on the property, the evidence that work has not commenced needs to be more extensive than with other types of transactions, and must include:
 - photographs of the property taken by the Approved Attorney or an independent third party accompanied by a photo affidavit or an inspection report prepared by the independent third party
and
 - an Affidavit of No Construction executed by Borrowers/Owners and General Contractor.
Here is a link to our Forms and Documents:
<http://www.pennattorneys.com/documents/index.html>

- (4) **Broken Priority – Construction Mortgage:** If broken priority exists and we are to insure an open-end construction mortgage, **special underwriting must be performed** in order to issue a loan policy without the general mechanics' lien exception. The following information will be requested. Please supply with application whenever possible:
 - A copy of the proposed mortgage to ensure that it complies with the definition of "open-end mortgage" in 42 Pa.C.S. §8143(f);
 - Proof that at least sixty percent (60%) of the loan proceeds are intended to be used to pay the costs of construction, which should include a copy of the construction loan agreement, a copy of the loan commitment letter, or an affidavit from the lender to that effect;
 - A copy of the construction budget and/or description of sources and uses for the project to determine whether the project is viable⁵;
 - A mechanics' lien indemnity from the owner.

³ Either (1) a seller take-back mortgage or (2) a mortgage to someone other than the seller in which all of the proceeds are used to pay all or part of the purchase price and the mortgage expressly states that it is a purchase money mortgage and it is recorded within 10 days of the date of settlement.

⁴ The mortgage is identified at the beginning thereof as an "open-end mortgage" and it clearly states that it secures future advances.

⁵ While priority is a very important defense when mechanics' liens arise, mechanics lien risk is always present in the context of construction loans. Therefore, in any construction related transaction PA/OBT's concern extends beyond priority and may include an assessment of the viability of the construction project. Even though there may be no identifiable loss of priority, mechanics' liens may still arise and cause title insurance defense losses if the construction project is underfunded, poorly planned or otherwise troubled.

- (5) **Broken Priority – Not a Construction Mortgage:** If broken priority exists and we are to insure a permanent loan following a construction mortgage, a modification of a construction mortgage, or a mortgage that does not meet the statutory requirements for an open-end construction mortgage or a purchase money mortgage, **special underwriting must be performed** in order to issue a loan policy without the general mechanics' lien exception. These types of transactions carry a greater mechanics' lien risk and must be underwritten accordingly. While the analysis is transaction specific, PA/OBT will require some or all of the following information to determine whether to give mechanics' lien coverage to a lender in one of these transactions:
- construction contract(s),
 - construction loan agreement(s),
 - a breakdown of the budget and sources and uses of funds for the project,
 - unconditional lien releases from the general contractor and subcontractors and suppliers for work performed or materials supplied,
 - financial information (preferably audited) for the proposed indemnitor(s).
 - In these situations, we will require an indemnity from the property owner and, depending on the specifics of the transaction, possibly additional parties.

This Underwriting Communication outlines the most typical situations presented in mechanics' lien underwriting, but the foregoing list is not exhaustive. In addition to variations on these scenarios, additional approaches and protections may also be available to assist with insuring over mechanics' lien risk in different situations.

Please contact us with questions or when faced with circumstances not addressed herein.

Note: Under the Approved Attorney system, the scope of our relationship is limited to the functions of underwriting and the issuance of title insurance policies on your behalf and does not include closing or escrow services. We sometimes provide information and recommendations with regard to your closing or escrow business as a courtesy to you. Moreover, some communications, depending on whether noncompliance could impact on liability under our policies or closing protection letters, should be considered directives. This Advisory is being provided to you with those considerations in mind.

WARNING: This Underwriting Communication is intended solely for the employees of Penn Attorneys/Ohio Bar Title Insurance Company and its Approved Attorneys, and is not to be distributed to third parties, and any reliance by any other person or entity is unauthorized. This Underwriting Communication is intended solely for the purpose of underwriting policies of Ohio Bar Title Insurance Company.

1250 Tower Lane, Suite 202, Erie, PA 16505
(800) 352-2216 FAX (800) 234-2352

PRE-CONSTRUCTION PHOTO AFFIDAVIT

Penn Attorneys/Ohio Bar Title's File No. _____

Premises: _____

Owners: _____

Contractor/Builder: _____

Photographer/Affiant: _____

COMMONWEALTH OF PENNSYLVANIA :
: §
COUNTY OF _____ :

On the ____ day of _____, A.D., _____, before me, a Notary Public in and for the Commonwealth of Pennsylvania, personally appeared:

who, being duly sworn according to law, and intending to be legally bound, deposes and says:

That I am eighteen years and upwards of age and under no legal disability; and

That on _____, _____, I personally took a photograph or photographs of the site referred to upon which the building is/are to be constructed for the above named owner; that at the time of taking the said photograph or photographs, a copy or copies of which are attached hereto identified by the photographer's signature and date and time of exposure, no materials, prefabricated or otherwise, were on the said ground and no work or labor had been commenced, in, upon or on the said ground and that the attached photograph or photographs is/are true and faithful pictorial representations of the condition of the said ground on the date and the time indicated.

Further affiant saith not.

Signature: _____

Print Name (Photographer): _____

Sworn to and subscribed before me, this ____ day of _____, _____.

Notary Public: _____ My Commission Expires: _____.