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Changes Made to the Pennsylvania Mechanics' Lien Law to Protect Holders of Open-End Mortgages and Residential Property Owners

By Raymond P. Pepe

Mechanics' liens grant contractors and subcontractors an interest in improvements made to real property to secure the payment obligations of owners to contractors, and of contractors to subcontractors. While these liens protect the legitimate interests of contractors and subcontractors, if mechanics' liens impair access to credit needed to finance construction and expose homeowners to financial risks beyond their reasonable and legitimate expectations, mechanics' liens may impede new construction in a manner clearly contrary to the interests of the contractors and subcontractors whose rights they seek to protect. Newly enacted Pennsylvania legislation attempts to better balance the interests of construction lenders, contractors, subcontractors and property owners.

On July 10, 2014, the Pennsylvania Mechanics' Lien Law was amended to provide that mechanics' liens are subordinate to an open-end mortgage that is recorded subsequent to the commencement of construction if at least 60% of the proceeds of open-end mortgages are used to pay for the costs of construction.¹ The term "costs of construction" is now defined broadly to include mandated off-site improvements, government impact fees, taxes, insurance, bonding, inspections, surveys, testing, permits, legal fees, architect and engineering fees, consulting fees, accounting fees, management fees, utility fees, tenant improvements, leasing commissions, the satisfaction of prior liens or mortgages, municipal claims, mortgage origination fees and commissions, finance and closing fees, recording costs, 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 prior law, as interpreted by the Pennsylvania Superior Court in *Commerce Bank v. Kessler*, a mechanic's lien relating to work commenced prior to the recording of an open-end mortgage was determined to not be subordinate to the open-end mortgage if any of the proceeds of the loan secured by the open-end mortgage were used to pay for anything other than the costs of completing erection, construction, alteration or repair of the mortgaged premises.²

Because most construction loans are used to pay for numerous items needed to facilitate construction, but not directly used in construction, such as taxes, fees for permits, insurance, closing costs, and the refinancing of existing debt, the *Kessler* decision made it more difficult for borrowers to close construction loans if construction had already begun and exposed construction lenders to a new set of complex and difficult to mitigate risks. The amendments to the Mechanics' Lien Law seek to restore a more reasonable balance between the interests

¹ Senate Bill 145, Printer's No 2208 (Approved as Act 117 of 2014 on July 1, 2014) (full text available at www.legis.state.pa.us).

² *Commerce Bank/Harrisburg, N.A. v. Kessler*, 46 A.3d 724 (2012), appeal denied per curiam, 62 A.3d 380 (2013).

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of borrowers, lenders, contractors and subcontractors. The expanded open-end mortgage priorities take effect on September 8, 2014, and apply to liens for work visibly commenced prior to the effective date that are not perfected until on or after September 8, 2014.

The legislation also amended the Mechanics' Lien Law to limit the extent to which the owners of residential property are subject to mechanics' liens. The legislation provides that a lien claim filed with respect to a residential property may be discharged when the owner or a tenant has paid the full contract price to the contractor. If the owner or tenant of a residential property has paid an amount less than the full contract price, the amendments allow a claim filed against a residential property to be reduced to the amount of the unpaid contract price. The legislation also provides that a subcontractor does not have a right to a lien when the owner or tenant paid the full contract price to the contractor if the property is a one- or two unit residential property or townhouse intended to be used as a residence of the owner, or used as the residence of a tenant subsequent to occupation by the owner.

No comparable protections for residential property owners were provided to home owners by prior law, and instead mechanics' lien claims were limited to the total amount of the contract price only if an owner was able to prove that subcontractors asserting claims had actual knowledge of the total contract price and the time payment was due to the general contractor, or the pertinent terms of the contract were filed with the county prothonotary prior to the commencement of construction, or at least 10 days prior to the execution of the general contract or a contract with a subcontractor. The limits on claims asserted against residential properties and townhouses take effect on September 8, 2014.

A more extensive analysis of the July 10, 2014 amendments to the Pennsylvania Mechanics Lien Law as published by the PA Banker's Association is available [here](#) that was also prepared by the author of this Real Estate Alert.

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