



Changes Made to the Pennsylvania Mechanics' Lien Law to Protect the Priority of Open-End Mortgages and Owners of Residential Property Who Have Paid Contractors

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Summary

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 9, 2014, the Pennsylvania Mechanics' Lien Law was amended to provide that mechanics' liens are subordinate to an open-end mortgage if at least 60% of the proceeds of open-end mortgages are used to pay for the costs of construction.² 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

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² Senate Bill 145, Printer's No 2208 (Approved as Act 117 of 2014 on July 9, 2014) (full text available at www.legis.state.pa.us).

open-end mortgage were used to pay for anything other than the costs of completing erection, construction, alteration or repair of the mortgaged premises.³

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 qualify for construction loans 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 of borrowers, lenders, contractors and subcontractors. The expanded open-end mortgage priorities take effect on September 7, 2014, and apply to liens for work visibly commenced prior to the effective date that are not perfected until on or after September 7, 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 7, 2014. No similar limits were imposed on claims in excess of the total contract price filed against owners of non-residential properties.

Background

A. Basic Lien Rights

Under the Pennsylvania Mechanics' Lien Law, every improvement and the estate or title of the owner in the improved property is subject to a lien for the payment of all debts due by the owner to the contractor, or by the contractor to any of its subcontractors, for labor or materials furnished

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

in the erection, construction, alteration or repair of the improvement, provided that the amount of the claim exceeds \$500.⁴

B. Scope of Mechanics' Lien Rights

Improvements subject to mechanics' liens include "any building, structure or other improvement of whatsoever kind or character erected or constructed on land, together with the fixtures and other personal property used in fitting up and equipping the same for the purpose for which it is intended." Property is subject to a mechanic's lien if it is "covered" by an improvement, or constitutes a lot or curtilage appurtenant to an improvement belonging to the same legal or equitable owner that is "reasonably needed for the general purposes thereof and forming a part of a single business or residential plant." The "owner" against whom a mechanic's lien claim may be filed is the owner in fee, a tenant for life or years, or any person "having any other estate in or title to property."⁵

Pennsylvania law broadly extends the right to assert a mechanic's lien as a contractor to any person, who by express or implied contract with an owner, erects, constructs, alters or repairs any part of an improvement; furnishes labor, skill or superintendence with respect to the erection, construction, alteration or repair of improvement; or supplies or hauls materials, fixtures, machinery or equipment reasonably necessary for and actually used in the construction, alteration or repair of an improvement. A architect and engineer qualifies as a contractor entitled to assert a mechanic's lien if, in addition to preparing drawings, specifications and contract documents for the owner, the architect or engineer also superintends or supervises the erection, construction, alteration or repair of an improvement.⁶

Subcontractors entitled to assert mechanics' liens include not only persons contracting directly with contractors, but also second-tier subcontractors who contract with another subcontractor in direct privity of contract with a contractor. With respect to subcontractors, mechanics' lien are not limited to the total contract price between the owner and the contractor unless the subcontractor has actual notice of the contract price and provisions for the time of payment, or the pertinent provisions of a contract are filed in the county prothonotary's office prior to the commencement of work or at least 10 days prior to execution of the principal contract or a contract with a subcontractor.⁷

C. Waiver of Mechanics' Liens

A contractor or subcontractor may waive the right to assert a mechanic's lien against residential property, but with respect to non-residential buildings, waivers are contrary to public policy unless given for payment actually received, or in exchange for a bond posted by a contractor guaranteeing payment to subcontractors.⁸ A waiver validly provided by a contractor is binding

⁴ 49 P.S. § 1301.

⁵ 49 P.S. § 1201(1) - (3).

⁶ 49 P.S. § 1201(4).

⁷ 49 P.S. §§ 1201(5) & 1405.

⁸ 49 P.S. § 1401.

on a subcontractor only if the subcontractor has actual notice of the waiver, or the waiver is filed with the prothonotary's office prior to the commencement of work, or within 10 days after execution of a contract with the principal contractor, or at least 10 days prior to the execution of a contract with the subcontractor.⁹

D. Perfection of Mechanics' Liens

To perfect a mechanic's lien, a claimant must file a claim with the county prothonotary within six months of completion of work by the claimant and give written notice of the claim within 30 days of filing to the property owner.¹⁰ Anytime after the completion of work, however, an owner or contractor may limit exposure to subcontractor's claims by filing a rule with the county court of common pleas requiring any named subcontractors to file a claim within 30 days or "be forever barred from so doing."¹¹ In addition, unless a rule is filed directing a subcontractor to file any claims within 30 days, a subcontractor may not assert a claim unless prior to filing the claim the subcontractor gives at least 30 days' notice to the owner of intent to file a claim.¹²

E. Priority of Mechanics' Liens

Liens against real property in Pennsylvania generally take priority from the time they are left for recording, recorded, rendered, left for entry in the county judgment index, issued or filed with the clerk of the court of common pleas.¹³ For example:

- Purchase money mortgages take priority from the time they are delivered to mortgagees (if recorded within 10 days) or are left for recording (if not recorded within 10 days).
- Other mortgages and defeasible deeds take priority from the time they are left for recording.
- Verdicts for specific sums of money take priority once they are recorded.
- Adverse judgments and other orders take priority when rendered, but amicable judgments take priority when left for entry in the county judgment index.
- The priority of writs creating liens is based on the time the writs are issued and indexed by the clerk of the county court of common pleas.
- All other instruments take priority when entered, filed and indexed by the clerk of the court of common pleas.

⁹ 49 P.S. § 1402.

¹⁰ 49 P.S. § 1502.

¹¹ 49 P.S. § 1506.

¹² 49 P.S. § 1501.

¹³ 42 Pa.C.S. § 8141.

Mechanics' liens may alter these usual rules of priority because once perfected, liens for the erection or construction of improvements generally take priority over other liens as of the date of the visible commencement of construction, and liens for the alteration or repair of improvements take priority as of the date filed with the county prothonotary.

Mechanics' liens do not take priority, however, over purchase money mortgages used to pay all or any part of the purchase price. In addition, under prior law, a mechanic's lien did not take priority over an open-end mortgage recorded subsequent to the commencement of work "the proceeds of which are used to pay all or part of the cost of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage."¹⁴

The term "open-end mortgage" refers to a mortgage which secures advances, up to a maximum amount of outstanding "indebtedness" stated in the mortgage, plus accrued and unpaid interest, provided the mortgage is identified as an "open-end mortgage" and clearly states that it secures future advances. The "indebtedness" secured by an open-end mortgage includes "extensions of credit secured by the mortgage made for the payment of taxes, assessments, maintenance charges, insurance premiums and costs incurred for the protection of the mortgaged premises."

In most cases, open-ended mortgages take priority over other obligations with respect to advances made after the mortgage is left for recording, but there are limits. If an advance is made after the holder of an open-end mortgage receives written notice of labor performed or material furnished or to be furnished for the erection, construction, alteration or repair of any part of the mortgage premises and the holder is not obligated to make the advance at the time the notice is received, then the lien to secure the advance is subordinate to a mechanic's lien, unless the advance is made in order to pay all or part of the cost of completing the construction of improvements the mortgage was given to secure.¹⁵

F. Impact of the *Kessler* Decision

The *Kessler* case involved a \$255,240 construction loan, more than \$95,000 of which was used to pay costs other than the costs of completing erection, construction, alteration or repair of the mortgaged premises, such as tax claims, closing costs, satisfaction of an existing mortgage, and payment of other judgments and liens. In resolving competing claims asserted by the mortgagee and by a contractor claiming a mechanic's lien, notwithstanding the broad definition of the term "indebtedness" in the definition of what constitutes an open-end mortgage, the Superior Court held that an open-end mortgage recorded subsequent to the commencement of work does not enjoy priority over a mechanic's lien if any portion of the proceeds of the loan are used for costs other than completing the erection, construction, alteration or repair of the mortgaged premises.

¹⁴ 49 P.S. § 1508.

¹⁵ 42 Pa.C.S. § 8143.

New Statutory Rules Establishing the Priority of Open-End Mortgages Over Mechanics' Liens

Effective September 7, 2014, a mechanic's lien is subordinate to an open-end mortgage recorded subsequent to the commencement of work "where at least sixty percent of the proceeds [of loans secured by the mortgage] are intended to pay or are used to pay all or part of the costs of construction."¹⁶ The term "costs of construction" is defined broadly to mean:¹⁷

[A]ll costs, expenses and reimbursements pertaining to erection, construction, alteration, repair, mandated off-site improvements, government impact fees and other construction-related costs, including, but not limited to, costs, expenses and reimbursements in the nature of taxes, insurance, bonding, inspections, surveys, testing, permits, legal fees, architect fees, engineering fees, consulting fees, accounting fees, management fees, utility fees, tenant improvements, leasing commissions, payment of prior filed or recorded liens or mortgages, including mechanics' liens, municipal claims, mortgage origination fees and commissions, finance costs, closing fees, recording fees, 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.

Reimbursements related to improvements include any disbursements "made to the borrower, any person acting for the benefit or on behalf of the borrower, or to an affiliate of the borrower."

Because the term "costs of construction" refers generally to "other construction-related costs," the types of construction-related costs specifically identified in the definition do not constitute an exclusive listing of construction-related costs. Instead, under principles of statutory construction, construction-related costs include other items not listed that are of the same general class as the items enumerated.¹⁸

The revised priorities afforded to open-end mortgages take effect on September 8, 2014, and apply to mechanics' liens perfected on or after September 8, 2014, including liens relating to the construction of improvements for which the visible commencement of work occurred previously, but were not perfected until on or after September 7, 2014¹⁹.

New Protections Provided to Owners of Residential Properties

Effective September 8, 2014, a mechanic's lien filed with respect to improvements made to a residential property may be discharged "upon a court order issued in response to a petition or

¹⁶ Senate Bill 145, § 3 (amending 49 P.S. § 1508(c)(2)).

¹⁷ Senate Bill 145, § 1 (amending 49 P.S. § 1201).

¹⁸ The rule of *ejusdem generis* provides that when general words in a statute are preceded or followed by specific examples, the general words are not to be construed in their broadest sense, but instead applied only to things of the same general class as those enumerated. *See e.g., McClellan v. Health Maintenance Organization of Pennsylvania*, 546 Pa. 463, 686 A.2d 801, 806 (Pa. 1996).

¹⁹ Senate Bill 145, § 5.

motion to the court by the owner or a party in interest,” if “the owner or tenant has paid the full contract price to the contractor.” In addition, where the owner or a tenant of a residential property paid a sum to the contractor less than the sum of the full contract price, upon issuance of a court order in response to a petition or motion to the court by the owner or a party in interest, a mechanic’s lien claim must “be reduced to the amount of the unpaid contract price owed by the owner or tenant to the contractor.”²⁰

The term “residential property” means “property on which there is or will be constructed a residential building not more than three stories in height, not including any basement level, regardless of whether any portion of that basement is at grade level.”²¹

The legislation also provides that a subcontractor does not have a right to a claim with respect to improvements to a residential property if (1) the owner or tenant paid the full contract price to the contractor; (2) the property is or is intended to be used as the residence of the owner or subsequent to occupation by the owner, a tenant of the owner; and (3) the residential property is “a single townhouse or a building that consists of one or two dwelling units used, intended or designed to be built, used, rented or leased for living purposes.” As used in the legislation, the term “townhouse” means “a single-family dwelling unit constructed in a group of three or more attached units in which each unit extends from foundation to roof with a yard or public way on at least two sides.”²²

These amendments provide relief to owners of residential property from claim by subcontractors for amounts in excess of the full contact price paid to the general contractor regardless of whether subcontractors have actual notice of the amount payable to the contractor and the terms of the agreement regarding the time of payment, or the terms of the agreement are filed with the county prothonotary. Because subcontractors are unlikely to have knowledge that payments have been made to the general contractor, to block or limit the assertion of liens by subcontractors, and avoid the need to petition for the discharge or reduction of the amount of liens claimed, owners should advise subcontractors of such payments after receiving notices of intent to file liens from subcontractors, or when filing a rule to bar claims not asserted within 30 days of the filing of the rule. Likewise, notice of the payment of amounts due to the contractor should be provided to subcontractors giving notice of intent to file a lien to avoid the assertion of claims subject to discharge, but not barred from being filed, because of the difference in the scope of the term “residential property” than the limits imposed on the right to claim a lien against a one or two unit residential dwelling or townhouse intended to be used as a residence of the owner or, subsequent to the occupation by the owner, by a tenant of the owner.

²⁰ Senate Bill 145, § 4 (amending 49 P.S. § 1510(f)).

²¹ 49 P.S. § 1201(14).

²² Senate Bill 145, § 2 (amending 49 P.A. § 1301).