

MAJOR CHANGES TO PENNSYLVANIA MECHANICS' LIEN LAW

Recently enacted modifications to the Commonwealth's Mechanics' Lien Law will have a widespread impact on those involved in the real estate development and financing industry.

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The first major amendments to Pennsylvania's Mechanics' Lien Law of 1963 take effect on January 1, 2007. Real estate developers, contractors, lenders, title insurance companies, and any other individuals or entities involved in the development or financing of real estate should be aware of these changes and how they affect their businesses.

The Pennsylvania Mechanics' Lien Law provides a statutory mechanism by which a contractor or subcontractor may subject the owner's real property to a lien "for the payment of all debts due by the owner to the contractor or by the contractor to any of his subcontractors for labor or materials furnished in the erection or construction, or the alteration or repair of the improvement, provided that the amount of the claim...shall exceed five hundred dollars (\$500)." However, under the prior version of the statute, these lien rights could be waived in advance, not only by the contractor and subcontractor personally, but also by the contractor on behalf of the subcontractors. In most land development projects undertaken prior to the amendments, the owner or his mortgage lender required the contractor to execute a waiver of the right to file mechanics' liens for himself and his subcontractors prior to the commencement of any work on the project. This waiver of liens was then filed with the Prothonotary of the county in which the project was located, and the contractor and all subcontractors and materialmen were thereafter estopped from filing a lien against the owner's property for payments due.

The most important component of the new legislation is a prohibition of this advance waiver of the right to file a lien, unless such waiver is given in exchange for advance payment of the contract price. The amendments provide that advance waivers of lien rights are "against public policy, unlawful and void, unless given in consideration for payments for the work, services, materials or equipment provided and only to the extent such payment is actually received..." **There are exceptions to this general rule, which are as follows:**

- Contractors and subcontractors may both waive their lien rights in advance on a residential project if the total amount of the contract between the owner and the contractor is less than One Million Dollars (\$1,000,000.00). A residential project is defined by the amendments as a property "on which there is a residential building, or which is zoned or otherwise approved for residential development, planned development or agricultural use, or for which a residential subdivision plan or planned residential development plan has received preliminary, tentative or final approval pursuant to the...Pennsylvania Municipalities Planning Code."
- Contractors and subcontractors may both waive their lien rights in advance on a residential project where the total amount of the contract between the owner and the contractor is more than One Million Dollars (\$1,000,000.00), or on a non-residential project, if the contractor has posted a bond guaranteeing payment for the labor and materials to be provided by the subcontractors.

In these situations, a contractor may continue to provide an advance waiver of the right to file a lien, for himself, and on behalf of the subcontractors.

While residential projects of less than one million dollars will most likely continue to be addressed in the same fashion as they were prior to the amendments (an advance waiver signed by the contractor which will bind subcontractors), other types of projects could prove more complicated for owners, lenders and

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contractors. The owners and lenders engaged in these projects will likely continue to request advance waivers of liens from the contractor, but this waiver will require the payment bond described above. The cost of that bond will be passed on to the owner, thereby increasing project costs, and the contractor will most likely also be required to post collateral to secure the bond. In the alternative, owners may prefer to accept the risk of proceeding without the advance waiver if they know and trust their contractor, but, assuming that their lender is also agreeable to that arrangement, the increased risk will likely be reflected in the loan pricing.

Subcontractors appear to be the primary beneficiary of the amendments, since all projects other than residential projects of less than one million dollars will either permit mechanics' liens to be filed or require a bond covering the payments due to them.

It should be noted, however, that the amendments also provide additional protection to certain types of lenders. While it is undesirable from a lender's perspective for a mechanic's lien to be filed against the borrower's property in any situation, **the amendments do provide that a mechanic's lien obtained by a contractor or subcontractor will be subordinate in lien priority to purchase money mortgages, and to open-end mortgages, if the proceeds of such open-end mortgage are used to pay for the cost of the erection, alteration or repair of the mortgaged property.** Thus, lenders who finance the acquisition of a property or the improvement of a property can be assured that the lien of their mortgage will take priority over any mechanics' liens filed against the property. However, lenders providing "take-out" financing or a refinance of a property do not enjoy this "super-priority", and therefore, must protect their lien priority through title insurance or additional due diligence. Unfortunately, the amendments do not address the issue of whether so-called "protective advances" made by a lender for taxes or insurance (as opposed to advances for erection, alteration or repair of the mortgaged property) pursuant to an open-end mortgage for improvement of a property also receive the super priority afforded by the amendments. In any event, where an advance waiver of liens has not been obtained, lenders should require a title "bring-down" and lien waivers for all work performed to date at the time that each loan draw is requested by the borrower.

Other noteworthy provisions of the amendments are as follows:

- **The amendments expand the scope of individuals involved in a project that are permitted to file a lien.** The prior law permitted only the contractor, and subcontractors who are engaged in a direct contractual relationship with the contractor, to file a lien. The amendments permit sub-subcontractors (those that are in a direct contractual relationship with a subcontractor, which subcontractor is in a direct contractual relationship with the contractor) to file a lien. This includes material suppliers.
- The amendments eliminate the requirement that subcontractors who provide alteration or repair work in connection with a project give preliminary notice of their intention to file a lien claim to the owner on or before the date the work is completed.
- Under the prior law, a claimant was required to file his or her claim with the Prothonotary within four (4) months after the date of completion of the work. The amendments extend this period to six (6) months.

If you have questions on the issues discussed in this alert, please contact Michael Clement or Jason Herron of Wisler Pearlstine at (610) 825-8400.