



Risks Associated With New Construction

Prepared by:
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Risks Associated With New Construction

1. Mechanic's liens are "secret" liens

Liens, defects and encumbrances affecting real property are generally discoverable from a search of the public land records. If in fact impairment of the title of the purchaser from pre-closing mortgages, consensual liens and other statutory liens is avoidable from a timely search of the public land records, why is this practical, preventative step not also the case for mechanic's liens? State laws providing for the attachment and priority of mechanics liens vary considerably. In many states, mechanics lien laws dictate that prospective real estate investors and homeowners face an ever-present potential risk of loss occasioned by lien claims when acquiring real estate in which work on the site occurred, regardless whether such work or its non-payment is known or suspected by the purchaser.

2. The long reach of mechanic's lien priority

Mechanics liens that pose the greatest risk to real estate investors are those that are "unfiled" or not filed of record at the point of closing or settlement: The lien right of the unpaid claimant exists by virtue of the improvements the lien claimant made at the site, but on the date that the purchaser or lender that lacks priority is to acquire their respective interests from the grantor, the lien claim was not as yet filed in the public land records. For example, Sec. 779.01(3), Wis. Stats., ensures for a portion of the lien's lifespan the lien's secret character by providing that "Any person who performs, furnishes or procures any work, labor, service, materials, plans, or specifications, used or consumed for the improvement of land, and who complies with s. 779.02 shall have a lien therefore on all interests in the land belonging to its owners," notwithstanding the lien claimant's failure to file a lien instrument in the public land records. Although operative law may require that the mechanic's lien shall be filed on or before a specific date or the lien claimant will lose its lien, the statute law may provide that the mechanic's lien shall relate back in time to the date at which the lien claimant's work occurred, well after the new owner became vested with title and after the loan secured by the permanent mortgage is recorded, thus impairing the purchaser's title and priming the mortgage.

3. The wide reach of mechanic's liens: To what land does the lien attach?

Mechanic's liens are particularly problematic for tract housing developers and their lenders. Depending upon state law, the mechanic's lien may extend to not just the land beneath or surrounding the newly constructed building but to all contiguous land of the owner who contracted for the work. In Wisconsin, construction liens may be filed against "the owner of any interest in land who... enters into a contract for the improvement of *land* (emphasis added)." §779.01(2)(c). To what "land" does the mechanic's lien attach? If the improvement is located wholly on one or more platted lots belonging to the owner, the lien applies only to the lots on which the improvement is located. §779.01(3)d, Wis. Stats. The recordation of a subdivision

plat under §236.25 prior to visible commencement of the work thus provides the landowner with the advantage of reducing the amount of land area subject to the liens of contractors. Mechanic's liens for grading and other types of lienable improvements which are performed on all lots or on a tract subdivided into lots, attach on a pro rata basis to each lot. Similarly, in the event of improvements on a condominium property, a construction lien will not be enforced against fewer than all of the units. §703.22, Wis. Stats.

4. Duration of mechanic's liens

Although mechanics lien laws will be liberally constructed to protect the rights of those who furnish labor and materials and who enhance the value of property, a law that mandates compliance rather than a law that is directory only, must be complied with for the mechanics lien to attach. Thus, in Arizona, the lien claimant's failure to file a lis pendens within the requisite time period resulted in the expiration of the mechanics lien. HCZ Constr., Inc. v. First Franklin Fin. Corp., 199 Ariz. 361, 18 P.3d 155 (App.2001). In Minnesota, the one-year limitation of the lien statutes is no ordinary statute of limitations; it puts a limit to the life and duration of the lien. Bauman v. Metzger, 145 Minn. 133, 138, 176 N.W. 497, 499 (1920). The statute requires that not only filing a complaint, but also making the defendant-landowner a party to the suit—accomplished by serving the defendant-landowner with the summons—must be done within one year. Smith v. Hurd, 50 Minn. 503, 507, 52 N.W. 922, 922 (1892). Where statute provided that action to foreclose mechanics lien must be filed within twelve months after completion of contract, the date on which the lien claimant and owner agreed that owner would finish the work, the fact that the materials furnished were not used until after the 1-year time period did not extend the time for completion and the mechanics lien expired. Govert Copier Painting v. Van Leeuwen, 801 P.2d 163 (Utah App.1990). The mechanics' lien expired one-year after lien claimant obtained valid extension of lien period, even though action to foreclose lien was commenced during extension period, where no notice of pendency as required by statute was filed within that period. Bianchi Constr. Corp. v. D'Egidio, 165 Misc.2d 973, 976, 630 N.Y.S.2d 904 (1995).

5. Loan Policy mechanics' lien coverage

Depending upon the extent to which the laws of the state accord the lender priority as against mechanics' liens on the basis of recordation of the mortgage prior to the filing of lien claims, mechanics' lien coverage may or may not be attainable for lenders. In jurisdictions in which timely mortgage recordation does not in and of itself assure the lender of priority, the lender is exposed to the risk of loss of priority when construction occurs. The form of title insurance coverage available to the lender will vary, depending upon whether the lender seeks coverage for construction that is ongoing or will continue, or alternatively, for construction that was completed.

a. Pending disbursement endorsement

In the event that construction is ongoing, and the loan secured by the mortgage is a construction loan, the lender may choose to obtain at the time the draw is disbursed an endorsement that specifies the amount disbursed by the title agent to date. Thus, an endorsement widely known as the “pending disbursement” endorsement may be available. Although there are many different versions, one version provides:

The Policy is now in force to the extent of \$ _____, being the loan proceeds disbursed to date. The Company hereby extends the Date of Policy as to Covered Risk 11 only, to _____, which is the date of the most recent disbursement of funds by the Insured. All other coverages provided by the Policy and endorsements thereto are not hereby extended.

b. Deletion of the standard mechanic’s lien exception

Before, during or after construction is completed, it is possible that the lender will strive to seek coverage that is expressed in the policy itself, rather than in an endorsement. Whether the title insurer will in fact agree to delete the exception for mechanic’s liens depends upon a fact-specific investigation and detailed analysis of applicable state law by the title insurer. In states having laws that accord absolute priority of mortgages over mechanic’s liens, it may be possible for the mortgagee to obtain loan policies in which the standard mechanic’s lien exception has been deleted. In other states, the form of coverage available will vary considerably and involves facts and circumstances beyond the scope of this discussion. In the current ALTA policy, the standard policy exception that encompasses mechanic’s liens is: “Any lien or right to a lien, for services, labor, or material heretofore or hereafter furnished, imposed by law and not shown by the public records.”

In the event that the title insurer has removed the standard exception for mechanic’s lien claims, Covered Risk 11 of the ALTA 2006 Loan Policy, which reads as follows, will provide the operative coverage against mechanic’s liens:

Subject to the exclusions from coverage, the exceptions from coverage contained in Schedule B, and the conditions, (title insurer) insures against loss or damage, not exceeding the Amount of Insurance, sustained or incurred by the Insured by reason of...

11. The lack of priority of the lien of the Insured Mortgage upon the Title (a) as security for each and every advance of proceeds of the loan secured by the Insured Mortgage over any statutory lien for services, labor, or material arising from construction of an improvement or work related to the Land when the improvement or work is either (i) contracted for or commenced on or before Date of Policy; or (ii) contracted for, commenced, or continued

after Date of Policy if the construction is financed, in whole or in part, by proceeds of the loan secured by the Insured Mortgage that the Insured has advanced or is obligated on Date of Policy to advance...

a. Interim coverage

ALTA Endorsements 32, 32.1, 32.2 and 33 are Loan Policy endorsements that were developed to give limited coverage where priority of the insured construction mortgage as to mechanic's liens has been lost. They only give coverage to the extent of work that the lender has paid for. They do not give coverage over other inchoate liens that can prime the construction mortgage. The 32-06 covers payment as disclosed by a draw request; the 32.1-06 is for use when payments are made directly to the sub-contractor or supplier, the 32.2 covers a lien filed for payment of previously paid amounts. ALTA Endorsements 32, 32.1, 32.2 and 33 provide "interim coverage." Coverage is limited to advances that were disbursed prior to the date on which disbursements were made, a date which the endorsements refer to as "Date of Coverage." Thus, each time a draw is disbursed, provided that the title insurer's criteria for issuing ALTA Endorsement 33 are met and ALTA Endorsement 33 is issued, coverage is extended by advancing the Date of Policy.

ALTA Endorsement 32 insures the priority of a construction loan disbursement where the Insured Mortgage does not have priority over mechanic's liens to the extent that the mechanic's lien arises from a misdisbursement of funds to pay for services, labor or material that "...were designated for payment in the documents supporting a Construction Loan Advance disbursed by or on behalf of the Insured on or before Date of Coverage."

ALTA Endorsement 32.1 insures the priority of a construction loan disbursement where the Insured Mortgage does not have priority over any mechanic lien to the extent that the mechanic's lien arises from a misdisbursement of funds to pay for services, labor or material "...to the extent that direct payment to the mechanic's lien claimant was made by the title insurer ("Company") or by the Insured with the Company's written approval." The effective coverage given is as to that portion of a mechanic's lien claim due to amounts that the Company acknowledges as having been directly paid to the claimant, either by the Company or under an agreement with a third party to pay directly. This coverage does not cover lower tier derivative liens such as material suppliers of a paid subcontractor.

ALTA Endorsement 32.2 insures the priority of a construction loan disbursement where the Insured Mortgage does not have priority over any mechanic's lien to the extent that the mechanic's lien arises from a disbursement of funds to pay for services, labor or material "...to the extent that direct payment to the mechanic's lien claimant was made by the Insured or on the Insured's behalf". The effective coverage given is as to that portion of a mechanic's lien claim due to amounts that

that the Insured actually paid directly to the claimant, or actual payments made on behalf of the Insured by a third party. This coverage does not cover lower tier derivative liens such as material suppliers of a paid subcontractor.

Lastly, ALTA Endorsement 33 modifies the Date of Coverage originally indicated in ALTA Endorsements 32, 32.1 and 32.2.

When ALTA Endorsements 32, 32.1 or 32.2 is issued, the following exception will be included in Schedule B of the Loan Policy in the place of the standard mechanic's lien exception:

Any statutory lien or claim of lien, affecting the Title, that arises from services provided, labor performed, or materials or equipment furnished, except as insured by the attached ALTA 32-06 Endorsement [or 32.1-06 or 32.2-06 whichever is used] as it may be revised by ALTA 33-06 (Disbursement) Endorsements.

6. Construction disbursing agent

The disbursement of construction mortgage loan draws typically requires an investigative process by which the lender, either with or without the assistance of a disbursing agent, procures extensive documentation, which it believes, will either avoid or timely elicit the existence of construction lien claims. The lender may require the general contractor to submit a cost breakdown, sworn affidavit identifying all subcontractors and materialmen, and lien waivers before authorizing any disbursement. As construction proceeds, the lender, owner, general contractor and disbursing agent may face any of a variety of unforeseen events requiring resolution to avoid the filing of lien claims, and which are beyond the scope of this discussion.

Impact of Remote Online Notarization (RON)

In the absence of recordation, conveyances will not impart constructive notice to purchasers, exposing the grantee to the risk that the conveyance is invalid. State laws condition recordation upon acknowledgement of the signatures of the grantor of the conveyance. The Covid-19 pandemic has presented some parties to what in pre-pandemic times would have been a simple conveyance execution process with physical impediments to in person notarization. In cases where a notary public is not available or the signer is unable to appear before a notary, the signer may decide to explore alternative forms of acknowledgement. Depending upon the specific circumstances of the transaction, remote online notarization, in states where it is recognized and where state law requirements are met by the signer, could provide an alternative.

Before remote online notarization can be considered, several requirements must be met. The parties must satisfy themselves that the conveyance will be accepted by the recorder of the county where the conveyance will be submitted for recordation. Parties to the transaction must agree that the remotely notarized conveyance and related documents are

enforceable. The title insurer must agree to insure the interest of the conveyance's grantee, including any mortgage. Finally, the lender must consent to the use of remote electronic notarization for loan documents.

Although many states have enacted remote online notarization ("RON") statutes, the statutes vary. At the present time, the American Land Title Association concludes that there are several notarization types and emergency options.

1. Remote online notarization
2. Paper remote online notarization
3. Remote ink notarization
4. Traditional wet ink notarization
5. In person electronic notarization

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