



Recent Superior Court Decision Places Lien Priority Granted to Open-End Mortgages at Risk

The Superior Court of Pennsylvania recently issued a two to one decision that will have an enormous impact on the Pennsylvania lending industry as it relates to open-end construction mortgages. The focus of the appeal was the applicability of the 2006 Amendments (the “Amendments”), effective January 1, 2007, to Pennsylvania’s Mechanic’s Lien Law, 49 P.S. 1101 et seq. The Amendments amended Pennsylvania’s Mechanic’s Lien Law and made significant changes to the law governing priority of liens and lien waivers. One such change made contractor and subcontractor lien waivers against public policy for non-residential projects. Additionally, the Amendments purportedly granted open-ended mortgages priority over mechanic’s liens, which represented a significant change from the prior law under certain circumstances. Particularly, under the pre-Amendment law, a subcontractor could back date its lien to the date when work was “visibly commenced” on the property. If that date pre-dated the open-end mortgage, the subcontractor would be granted priority. With regard to the issue of priority, the purpose of the Amendments was to make mechanic’s liens subordinate to “bank liens” so as not to freeze lending.¹ The

decision of the Superior Court of Pennsylvania in *Commerce Bank/Harrisburg, N.A. v. Kessler*, 2012 Pa. Super. 100, defies the purpose of 2006 Amendments relating to priority and, in many circumstances, places that priority in jeopardy under normal and customary lending practices in Pennsylvania.

Specifically, in *Kessler*, the Superior Court addressed the priority of liens between the holder of an open-end mortgage and the project contractor (“Contractor”). The construction contract was entered into prior to the effective date of the Amendments and the open-end mortgage post-dated the Amendments. Under the pre-Amendment mechanic’s lien law, absent a lien waiver, the contractor would have had priority over the holder of the open-end mortgage because work had visibly commenced prior to the recording of the open-end mortgage. However, due to the Amendments, the priority of the liens was at issue.

In the lower court, the Contractor successfully argued that its lien had priority due to its contract pre-dating the effective date of the Amendments. Particularly, the Contractor argued that to apply the Amendments to its contract would be to apply a statute retroactively in violation of Pennsylvania law. The Lender disagreed with this position and argued that applying the Amendments were not affecting the Contractor’s contractual rights, but were changing the Contractor’s statutory rights, which could be freely changed by the legislature. The Superior Court agreed with the Lender and held that because the Contractor “obtained” its lien under the Mechanic’s Lien Law as amended; it was bound by the provisions thereof. After seemingly making a major decision in favor of the Lender, the Superior Court reversed course and affirmed the lower court based on other grounds. The Contractor argued that even though the

Amendments applied, the open-end mortgage at issue did not comply with the statutory requirements in order to gain priority. The Section at issue grants priority to “[a]n open-end mortgage as defined in 42 Pa.C.S. 8143(f) (relating to open-end mortgages), the proceeds of which are used to pay all or part of the costs of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage.” The parties stipulated that portions of the proceeds of the open-end mortgage were used to pay for tax claims, closing costs, satisfaction of an existing mortgage and to satisfy other judgments and liens. Though both parties agreed that certain money spent did not go towards “completing erection, construction, alteration or repair,” the Lender argued that because Section 8143(f) also contained the definition of the word “indebtedness,” that paying for expenses included within that definition should be permissible. This position was supported by the argument that the definition of “open-end mortgage” including the word indebtedness and, therefore, the definition of indebtedness should be considered. The Superior Court disagreed and held that because indebtedness was not specifically referenced by the legislature, it could not be considered. As such, the Superior Court held that because not every dollar of the open-end mortgage went to “completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage,” the Contractor had priority over the open-end mortgage.

While there are still open and remaining issues relating to the Amendments and the applicability of Section 1508(c), this holding makes clear that paying certain costs at the time of closing that would otherwise be properly included in an open-end mortgage, such as those costs described in Kessler, removes the

open-ended mortgage from the protected class. Moreover, in an unrelated matter, an argument has been made that Kessler also prevents the payments of soft costs related to construction. Though this issue is not addressed directly by Kessler and strong arguments favor inclusion of these costs, based on the holding in that matter, it is unclear whether the Court will deem these costs permissible. Unless the decision in Kessler is reversed through a rehearing en banc or by the PA Supreme Court, this is the law in Pennsylvania. Accordingly, it is important for all Pennsylvania lenders to immediately examine their outstanding open-end mortgages and determine whether they are at risk.

Going forward, Lenders entering into a project will have two choices. First, they can ensure that the open-end mortgages pays for nothing other than the costs allowed by the Mechanic’s Lien Law as Amended. This may be difficult because, inherently, an open-end mortgage allows for many other costs to be covered. Second, and though costly, a Lender may be forced to essentially shut down a project, pay off all of the contractors, remove all equipment from the project site, close the new loan, and then start a new second project after the mortgage has been recorded. Although difficult, due to the strict requirements imposed by the recent Superior Court opinion, this may be the safest alternative.

This decision also has significant ramifications for the title insurance industry. After Kessler, it is now a risk to insure any construction loan that pays for costs other than those that are pure hard construction costs. It is clear that after Kessler, open-end mortgages that cover acquisition costs cannot be insured without exception for mechanic lien claims. The recent Superior Court opinion also puts into questions whether loans that pay for soft construction costs would be granted

priority over mechanic lien claims. Until this issue is resolved, insuring these types of loans without exceptions for mechanic liens comes with a substantial risk. Though cast as an opinion on statutory interpretation, this recent opinion seemingly flies in the face of Pennsylvania lending practices and leads to more questions than it does answers. Due to the amount of dollars that are often involved in these types of transactions, this opinion should be immediately contemplated and analyzed by this Commonwealth’s lending institutions.

1 See purpose as stated in correspondence from Lou Bacchi, Director of Governmental Affairs for the Pennsylvania Builders Association to Representative George Kenney, a bill sponsor, dated June 26, 2006.

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Editor’s note: The Pennsylvania legislature is considering major changes to the Mechanics Lien Law of 2007. NAIOP Pittsburgh was one of a number of industry associations advocating changes to provide owner’s notice of subcontractors and suppliers working on a project, as well as several other revisions. House Bill 16202 passed March 27 by a margin of 190-6. The bill will now be considered by the Senate. DP