

NAVIGATING MECHANIC'S LIEN COVERAGE

PRESENTED BY:

Dale B. Rycraft Jr.
New Mexico Underwriting Counsel

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I. INTRODUCTION

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What is THE single most frequent mechanic's lien underwriting question I get?

DOES [BLANK] BREAK PRIORITY?

What is the SECOND most frequent question I get?

What do you need to approve my mechanic's lien coverage request?

What's the big deal with construction loans?

- Priority of the Insured Mortgage over Mechanic's Liens
- Historically, Mechanic's Liens are one of the greatest sources of loss to the land title industry.
- Single biggest loss in the history of my company was a ML claim
- Mechanic's Liens are Inchoate Liens (Not yet perfected)
- Relation-back Rule – ALL mechanic's liens relate back to the date construction commenced

Construction Loan

A loan that provides the financing to build, remodel, or repair a house, structure, project, development or other improvements to land.

Types of transactions where mechanic's liens may be a risk:

- ❖ New Construction Financing
- ❖ Recently completed new construction
- ❖ Renovations, improvements or remodels
- ❖ Tenant improvements
- ❖ Repairs

What is the title agent's role and responsibility with respect to mechanic's lien risks?

To help reduce the underwriter's exposure to mechanic's lien risks and claims.

II. MECHANIC'S LIEN COVERAGE UNDER NEW MEXICO'S LOAN TITLE POLICY FORM

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Standard Coverage – Priority of the Insured Mortgage over all other liens:

- **Covered Risks 2 and 10**
- **Covered Risk 11(a)**
- **Exclusion 3(a) and (d)**
- **Standard Exception # 4 [Schedule BI]**
- **Conditions – Definition of “Indebtedness”**

Covered Risk # 2: Any lien

2. *Any defect in or lien or encumbrance on the Title.*

Covered Risk # 10: Lost priority

10. The lack of priority of the lien of the Insured Mortgage over any other lien or encumbrance.

Covered Risk # 11(a): Mechanic's liens

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** the 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



Coverage Limitation – Exclusion 3:

3. Defects, liens, encumbrances, adverse claims, or other matters

a) **created, suffered, assumed, or agreed to** by the Insured Claimant;

d) **attaching or created subsequent to Date of Policy** (however, this does not modify or limit the coverage provided under Covered Risks 11, 13, or 14)

Coverage Limitation – Standard Exception #4:

This policy does not insure against loss or damage, and the Company will not pay costs, attorneys' fees, or expenses that arise by reason of:

4. Any lien, claim or right to a lien, for services, labor or material heretofore or hereafter furnished, imposed by law and not shown by the public records.

Conditions – 1. Definition of Terms:

- (d) “**Indebtedness**”: The obligation secured by the Insured Mortgage including one evidenced by electronic means authorized by law, and if that obligation is the payment of a debt, the Indebtedness is the sum of
- (i) the amount of the principal disbursed as of Date of Policy;
 - (ii) the amount of the principal disbursed subsequent to Date of Policy;
 - (iii) the construction loan advances made subsequent to Date of Policy for the purpose of financing in whole or in part the construction of an improvement to the Land or related to the Land that the Insured was and continued to be obligated to advance at Date of Policy and at the date of the advance;**
- etc.

Construction Loan Two-Year Claims Made Limitation: [NMAC 13.14.9.40(A)]

"Notwithstanding any other provision of this policy, the company shall be liable only for such loss or damage insured against by this policy which is actually sustained by the insured and reported to the company as provided in the conditions and stipulations on or before two years after the recording of the mortgage described in schedule A."

May elect up to four 6-month extensions: [NMAC 13.14.7.18(B)]

“...a standard loan policy with a two-year claims made limitation may be extended by issuance of no more than **four extension endorsements of six months each**. In no event may the coverage provided by a construction loan policy or a standard loan policy with a two-year claims made limitation, if extended to its maximum, exceed four years from the date of issue unless it is converted to a loan policy by payment of the full premium due”

Two Options for Mechanic's Lien Coverage:

1. Full Upfront Coverage
2. Incremental Coverage

Full Upfront Coverage - Deletion of Standard Exception #4 pursuant to NMAC 13.14.5.12(D):

- (1) In an owner's policy, standard exception 4 may be deleted in only one of two circumstances:
- (a) **the statutory period for filing mechanics' or materialmen's liens expires prior to the date of the policy;**
 - (a) some or all of the improvements will be "new construction" (or recently completed), and **the statutory period for the filing of said liens will not have expired;** or
 - (b) in either circumstance the construction of all improvements on the insured property must have been **fully completed and accepted by the insured owner** and the appropriate additional premiums required by these rules must be paid.

COMPARE OWNER'S POLICY:

(2) In a loan policy, standard exception 4 may be deleted in only one of two circumstances:

- (a) [NO BROKEN PRIORITY] if the insurer's underwriting requirements **for evidence of priority** have been met; or
- (b) [BROKEN PRIORITY] if the insurer's underwriting requirements **for evidence of priority have not been met but the insurer's underwriting requirements of the risk incurred by reason of the lack of priority have been met.**
- (c) In either circumstance, the appropriate additional premiums as established in a title rate case shall be paid.

Incremental Coverage – NM 83 and NM 84 Endorsements:

NM 83 – Construction Loan Endorsements (Bank)

- NM 83.1 – Insurer Direct Payment (Title Co.)
- NM 83.2 – Insured Direct Payment (Not a Bank)

NM 84 - Disbursements

NM 83 – Construction Loan Endorsement:

1. **Covered Risk 11(a) of this policy is deleted.**
2. Definitions
- 3(a) **Invalidity or unenforceability** of lien for each advance.
- 3(b) **Lack of priority** of lien for each advance
- 3(c) **Inchoate Lien Coverage** for work completed and paid for.
["were designated for payment in documents supporting a Construction Loan Advance disbursed by or on behalf of the Insured"]
4. No coverage if no pay app or for work after Date of Coverage (as modified by NM 84)

NM 84 Disbursement Endorsement:

1. The Date of Coverage is amended to _____.
[a The current disbursement is \$_____.]
[b. The aggregate amount, including the current disbursement, recognized by the Company as disbursed by the Insured is: \$_____.]
2. Schedule A is amended as follows:
3. Schedule B is amended as follows:
[Part I]
[Part II]

Full Upfront vs. Incremental Comparison

FULL UPFRONT	INCREMENTAL
Standard Exception # 4 Deleted	Standard Exception #4 Deleted (and replaced with a special exception) Covered Risk #11(a) Deleted
Coverage Per Covered Risk #11(a)	Coverage Per NM 83 and NM 84
Priority of lender's lien whether work commenced BEFORE or AFTER the date of policy	Coverage limited to: <ul style="list-style-type: none">• Lien rights accrued on or before the date of the endorsement• Amount stated in the endorsement (Coverage linked to disbursements) <u>Objective</u> : control disbursements so that ML are avoided.
Common Use: When NO Broken Priority	Common Use: When Priority is Broken

Specific Endorsement for NM 83/NM 84:

Any statutory lien or claim of lien, not shown by the Public Records at Date of Policy, that arises from services provided, labor performed, or materials or equipment furnished, except as insured by the NM 83 Construction Loan Endorsement as it may be revised by any NM 84 Disbursement Endorsement.

What this specific exception does (From ALTA):

This makes it clear that notwithstanding Covered Risks 2 and 10, the only coverage we are providing for mechanics' liens is by way of the endorsements attached to the policy.

III. NEW MEXICO MECHANIC'S LIEN LAW PRIMER

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What is a mechanic's lien?

A security interest in real property for the benefit of those who provide services, labor, materials or equipment to improve, repair or renovate real property.

Who may record a mechanic's lien?

A lien may be claimed by “[e]very person performing labor upon, providing or hauling equipment, tools or machinery for or furnishing materials to be used in the construction, alteration or repair” of any improvement, including a **surveyor**, for the contracted amount, whether provided at the instance of the owner or his agent, which includes “[e]very contractor, subcontractor, architect, builder or other person having charge of any . . . of the construction, alteration or repair. . . .”

NMSA § 48-2-2

3 Steps to Perfect a Mechanic's Lien

Steps	General Contractors	Subcontractors & Laborers	Material Suppliers & Others
Preliminary Notice	Not Required if contracted directly with owner	60 Days after initially furnishing work or material, or both - IF: 1. <u>Didn't Contract Directly</u> with Property Owner or Original Contractor 2. Claim is for <u>more than \$5,000</u> 3. NOT a residential project with less than 4 dwellings.	60 Days after initially furnishing work or material, or both - IF: 1. <u>Didn't Contract Directly</u> with Property Owner or Original Contractor 2. Claim is for <u>more than \$5,000</u> 3. NOT a residential project with less than 4 dwellings.
Record Claim of Lien	120 Days after COMPLETION of CONTRACT N.M. Stat. Ann. § 48-2-6	90 Days after COMPLETION of IMPROVEMENT N.M. Stat. Ann. § 48-2-6	90 Days after COMPLETION of IMPROVEMENT N.M. Stat. Ann. § 48-2-6
File Lien Foreclosure Action	2 Years from date LIEN RECORDED	2 Years from date LIEN RECORDED	2 Years from date LIEN RECORDED

PRIORITY of a mechanic's lien:

48-2-5. Preference over other encumbrances.

- A. The liens provided for in Sections 48-2-1 through 48-2-17 NMSA 1978 are preferred to any lien, mortgage or other encumbrance which may have attached subsequent to the time when the building, improvement or structure **was commenced, work done or materials were commenced to be furnished**; also to any lien, mortgage or other encumbrance of which the **lienholder had no notice and which was unrecorded at the time the building, improvement or structure was commenced**, work done or the materials were commenced to be furnished.
- B. Liens filed by **registered surveyors shall have priority equal with other mechanics' and materialmen's liens, but work performed by registered surveyors shall not constitute the commencement of construction.**

Section 48-2-5 NMSA 1978.

“Relation-back Rule”

A subcontractor's lien **relates back to the date when any construction actually commenced**, even though that subcontractor's work commenced after the mortgage was recorded.

Pioneer Sav. & Tr., F.A. v. Rue, 109 N.M. 228, 784 P.2d 415 (1989)

What constitutes “*commencement*?”

In order for work to constitute a “commencement” such **work must have been done on the "building, improvement or structure" upon which the lien is claimed**. [citations omitted).

Accordingly, work done that is not a part of the "building, improvement or structure" is irrelevant in assessing lien priorities.

Pioneer Sav. & Tr., F.A. v. Rue, 109 N.M. 228, 784 P.2d 415 (1989)

Examples of work that evidences “*commencement*”:

- ❖ Demolition and removal of existing structures.
- ❖ Any disturbance of the surface in preparation for construction
- ❖ Ground-breaking ceremonies
- ❖ Location of construction shed or trailer on the site
- ❖ Installation of temporary electric power post
- ❖ Delivery of materials or construction equipment to the site
- ❖ Site grading and/or well drilling
- ❖ Foundation trenching or staking
- ❖ Installation of septic system

What constitutes “*completion*”?

“Completion” as used in former 61-2-6, 1953 Comp. (now 48-2-6 NMSA 1978), refers to **substantial completion**, which occurs when the **essentials necessary to the purpose of the building under construction have been performed.**

Tabet Lumber Co. v. Baughman, 79 N.M. 57, 439 P.2d 706 (N.M. 1968).

Claim of Lien Requirements to be valid and enforceable:

- Amount of claim, after deducting all just credits and offsets
- Name of project owner
- Name of person by whom lien claimant was employed or to whom he furnished materials
- Statement of the contract terms and conditions, including payment terms
- Description of property being lienied, sufficient for ID.
- Verified by oath.
- Filed for record within statutory time limits.

NMSA § 48-2-6

Why mechanic's liens happen:

1. The developer may not have planned appropriately, resulting in unpaid contractors, subcontractors, and material suppliers.
2. The developer may use the construction funds for other purposes.
3. The developer may choose not to pay a contractor if the developer believes the work was inadequately done.
4. Unexpected work may be needed.

V. UNDERWRITING CONSTRUCTION LOANS

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Underwriting Construction Loans

Preliminary Questions:

- ☐ What Type of Project is it?
- ☐ What level of ML coverage is requested?
- ☐ Is Priority Broken?

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KNOW THE PROJECT!

- ❖ What is being constructed?
- ❖ Is borrower the landowner or tenant?
- ❖ What is the experience and reputation of the borrower?
- ❖ Who is the builder?
- ❖ What's the builder's reputation and experience with this type of project?
- ❖ Who is the lender?
- ❖ What's the lender's reputation and experience with construction loans?
- ❖ What is the construction loan disbursement control process?
- ❖ Do you know the borrower, builder and/or lender?
- ❖ If so, what's your opinion of them?
- ❖ Have you done other deals for any of them?
- ❖ Are there any unusual risks with this project?

What level of ML Coverage is Requested?

Standard	Full Upfront	Incremental
No Deletions or Endorsements	Delete Standard Exception #4	Delete Standard Exception #4 and use NM 83 and NM 84 [which delete Coverage 11(a)]
No post-closing ML Coverage	Full ML Coverage	Incremental ML Coverage
Least Risk	Most Risk	Managed Risk

Underwriting Construction Loans

Is Priority Broken?

NOT Broken	BROKEN
Construction mortgage recorded BEFORE any work commenced	Construction mortgage recorded AFTER work commenced
Normal Scrutiny	Heightened Scrutiny
Standard, Full Upfront or Incremental	Incremental Only

IMPORTANT!

Prevent a break from occurring prior to COE!

1. **ADVISE** - the Owner and the Contractor NOT to perform work of ANY SORT before recording;

AND

2. **INSPECTIONS** – Two inspections to document that no construction has commenced before recording:

- 1) IMMEDIATELY upon receipt of order; and
- 2) DAY of RECORDING.

Two Primary Underwriting Concerns:

	PRIORITY	VIABILITY
Issue	Will the insured mortgage have priority over mechanic's liens?	Is there enough money available to complete the project?
Reason	<u>Inchoate Lien Coverage:</u> <ul style="list-style-type: none">• Covered Risks 10 & 11(a)• Standard Exception #4 Deleted• NM 83 Covered Risk 3(b)	ML risk substantially greater on projects under financial distress
Inquiry	Unbroken or Broken	<ul style="list-style-type: none">• Sources and Uses of Funds• Experience of Players• Disbursement controls

Underwriting Construction Loans

	Priority Not Broken	Broken Priority
Coverage	<ul style="list-style-type: none"> • Full Upfront [Delete # 4] • Incremental [NM 83 & 84] 	<ul style="list-style-type: none"> • Incremental [NM 83 & 84]
Two Basic Documents	<ol style="list-style-type: none"> 1. Construction Loan Agreement (Including Sources and Uses Report) 2. Construction Contract 	<ol style="list-style-type: none"> 1. Construction Loan Agreement (Including Sources and Uses Report) 2. Construction Contract
Possible Additional Documents (Higher risk = more safeguards)	<ol style="list-style-type: none"> 1. Owner's Affidavit 2. Survey or Surveyor's Report 3. Inspection Photographs 4. Construction Budget/Cost Break-down 5. Fund disbursement control procedures 6. Indemnity Agreement 	<ol style="list-style-type: none"> 1. Owner's Affidavit 2. Survey or Surveyor's Report 3. Inspection Photographs 4. Construction Budget/Cost Break-down 5. Fund disbursement control procedures 6. Indemnity Agreement 7. Financial Statements or Loan Application from the owner/borrower 8. Financial Statements from Indemnitors 9. Financial Statements from G/C 10. Mechanic's Lien Waivers and Releases 11. As-built appraisal 12. Payment and performance bonds 13. List of Subs & Material Suppliers 14. Leases between owner and future tenants (executed)



QUESTIONS



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CONSTRUCTION LOANS

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