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Construction Lending Conundrum: Impact of a Recent Mechanics' Lien Case

By: Donald R. Geiter, CIPP/US

In what then seemed to be a victory for construction lenders, amendments to Pennsylvania's mechanics' lien law were made effective January 1, 2007 giving lenders a perceived advantage over mechanics' lien claimants. Specifically, the new law gave lenders apparent priority to the lenders' purchase-money mortgages and construction mortgages over a mechanics' lien filed later in time. This was all good news for lenders because, until the amendments, the law allowed contractors with mechanics' liens to "leap frog" over a lender's mortgage on the same property to the date that construction first began on the property. You may recall that pre-2007, this resulted in lenders taking all sorts of precautions to ensure that no construction began until after the lender's mortgage was recorded -- including visiting and photographing the worksite the day of closing to confirm no construction has started. Most of these precautions had since ceased, given the 2007 amendments.

Unfortunately, however, a recent Superior Court case, Commerce Bank/Harrisburg, N. A., v. Stephen F. Kessler and Lisa K. Kessler, and Michael Kevin Ricker v. Metro Bank, F. K. A. Commerce Bank of Harrisburg N. A., 2012 WL 1610139, may now require lenders to start taking these precautions again, as this new case seemingly takes away the advantages lenders thought they had and has the potential to overhaul the way in which lender's make construction-related loans going forward.

At first glance, it appeared that the primary issue the Superior Court had to decide in the case was the "straddling issue" of how to treat projects under the mechanics' lien law that started prior to the effective date of the 2007 amendments. Therefore, the apparent question in the case seemed to be whether a contractor, who began work in October 2006, could avail itself of lien priority over a bank that filed a mortgage on the same property in January 2007. The lower court granted the contractor priority -- refusing to apply the amendments retroactively. On this issue, the Superior Court reversed the lower court's decision and found the amended law did apply retroactively. But then the Superior Court went one step further -- it went on to interpret the law as requiring all of the proceeds of the bank's mortgage loan to be applied to construction costs (i.e., "hard costs") in order for the bank to avail itself of priority if construction started before the mortgage is recorded. It was on this basis that the contractor retained lien priority, since some of the proceeds from the loan went to the "soft costs".

The contractor's winning argument was based on the Court's very strict reading of the exception set forth in Section 1508 c-2 of the Pennsylvania Mechanics' Lien Law -- which gives priority to an open-ended mortgage loan filed subsequent to the commencement of a contractor's work only if " the proceeds are used to pay all or part of the cost of completing erection, construction, alteration or repair of the mortgaged premises ". The contractor argued that the bank failed to qualify for the exception since approximately $95,000 of the mortgage loan proceeds paid for expenses other than the "completing, erection, construction, alteration or repair of the mortgaged premises". Since this fact was stipulated and agreed to by the parties, the Court was left solely with the task of determining whether all proceeds were required by the law to use for construction, repair or alteration, in order for the bank to have priority over the contractor that began construction before the loan was made.

The Court determined that the proceeds of the mortgage loan can only be used for actual construction costs to qualify for the exception. It took the position that the term "proceeds" means all of the proceeds -- agreeing with the contractor's argument that even if $1.00 of the proceeds were used for "soft cost" purposes (i.e., closing costs, back taxes or satisfying an outstanding mortgage), then the mortgage would not qualify for the exception and would lose priority to the mechanics' lien.

Lenders must consider that this decision, coupled with the remaining provisions of the law that were changed by the 2007 amendments but unchanged by this case (i.e., expanded period of time to file mechanics' lien, additional layer of potential lien claimants, and the elimination of "stips" in commercial projects unless bonded), will increase the chances that a mechanics' lien could gain priority over the lender's mortgage. As a result, we expect that lenders are considering immediate changes in the manner in which purchase money and construction loans are made. For instance, it now becomes important again to determine if construction has started before extending credit. If a lender advances loan proceeds after a contractor has started, the lender now must be aware that the contractor may have priority if any proceeds of the mortgage loan are used for any purpose unrelated to construction, modification or repair of the mortgaged property, including "soft costs". This decision will also likely impact title insurance coverage, as it is expected that insurers will no longer simply delete the mechanics' lien exception to lender's policies.

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Bankruptcy Decisions You Should Know

By: Timothy G. Dietrich

Every now and then, a few cases that are clearly critical to commercial lending and loan recoveries float to the surface of the flood of bankruptcy court opinions. This is the first in a series of short synopses of cases that you should factor into your strategies.

Upstream Subsidiary Guaranty As A Fraudulent Conveyance

The case of In re TOUSA has been widely followed on appeal and is among the most significant in the country. Simply stated, the U.S. Bankruptcy Court for the Southern District of Florida found (1) that the granting of a guaranty by subsidiary corporations to secure more than $420,000,000 of new loans extended to the parent corporation, secured by liens on the corporate assets of the subsidiaries, was an avoidable fraudulent conveyance. The new lender provided funding for a compromise and settlement of prior secured debts, which rendered the parent company, in the opinion of the Court, the "most highly - leveraged company in the industry". TOUSA, Inc. was a large residential builder. Six months later, the parent company and all of its subsidiaries filed a Chapter 11 case. The fraudulent conveyance claim was advanced against the original lenders who received the compromise and settlement payment and they were ordered to return the $420,000,000 payment.

The Bankruptcy Code provides, in Section 548, that a trustee may avoid as fraudulent any transfer of an interest of the debtor (such as a lien) if the debtor received less than reasonably equivalent value in exchange for the transfer and the debtor was insolvent at the time or rendered insolvent as a result of the transfer. Obviously, to the extent that a transfer is avoided under Section 548 of the Bankruptcy Code, the trustee may recover the property transferred, either from the initial transferee or from an entity which benefited from the transfer.

The Bankruptcy Court found that the subsidiaries were, in fact, insolvent at the time that the guaranty and new collateral were granted and that the subsidiaries did not receive reasonably equivalent value for the guaranty and liens. The Court found that the subsidiaries received indirect and minimal benefits from the transaction and rejected the contention that avoidance of contingent claims, avoidance of litigation or avoidance of imminent bankruptcy were sufficient consideration.

On appeal, the U.S. District Court reversed the decision of the Bankruptcy Court.(2) On further appeal to the U.S. Court of Appeals for the Eleventh Circuit, the District Court was reversed and the Eleventh Circuit essentially overruled the District Court and supported the original trial court decision. (3)

The Bankruptcy Court also discounted the viability of insolvency "savings clauses" in the subsidiary guaranty, which are not unusual in these transactions and purport to have the effect of reducing the amount of the guaranty by a sum sufficient to assure that the subsidiary remains solvent, thereby preventing a fraudulent conveyance claim. Neither the District Court nor the Eleventh Circuit ruled on the validity or effect of the savings clause.

The TOUSA decision may ultimately be little more than an obvious response to a refinancing occurring six months before a bankruptcy filing and the court's judgment about the lenders' due diligence. Nevertheless, the case raises several points that should be considered by both lenders and workout officers. For example:

(a) Due diligence on the financial condition and solvency of the subsidiary providing a guaranty must be thoroughly conducted and the creation of contemporary evidence of solvency at the time of the transaction is essential to the enforcement of the upstream guaranty.

(b) Incidental and intangible benefits to the subsidiary providing the guaranty, particularly in a setting where the companies are already stressed or in trouble, is unlikely to win the day in defending against a fraudulent conveyance claim. More concrete benefits must be identified - and documented. Some lenders resort to a "co-borrower" structure to work around the benefits/consideration problem. We urge caution in a co-borrower structure where there is ample evidence that the parties have no expectation that the subsidiary will borrow under the credit facility.

(c) The degree of foreseeability of subsequent financial difficulty must be assessed and a lack of credible evidence supporting the lender's or recipient's contention that they could not anticipate subsequent insolvency will be problematic.

(d) Credit underwriting decisions which rely upon the value of subsidiary assets and upstream guaranties have been common in the past, with the lender often arguing that the subsidiary received "indirect value", even though it did not receive loan proceeds. The TOUSA decision indicates that the possible prevention of an immediate bankruptcy filing is not "reasonably equivalent value", in and of itself. Upstream guarantys should be discounted as a credit support in the credit underwriting process, unless the lender can identify either (1) that the subsidiary will receive a direct and demonstrable benefit from the transaction or (2) the subsidiary was clearly, as shown by evidence, solvent at the time of the transaction.

(e) Receiving payoff proceeds from a transaction involving other funding sources, which include an upstream guaranty, may subject the recipient of the payoff to a fraudulent conveyance claim and to a refund of the payoff. Again, due diligence is necessary in any material payoff or settlement situation.

(f) Continue using "savings clauses" in upstream guaranties. Their protective value has not yet been finally determined.____________________________

(1) Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am. Inc. (In re TOUSA Inc.), 422 B.R. 783 (Bankr. S.D. Fla. 2009).
(2) 3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA Inc. (In re TOUSA Inc.), 444 B.R. 613 (S.D. Fla. 2011).
(3) Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA Inc.), 680 F.3d 1298 (11th Cir. 2012).

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What Every Business and Lender Should Know About PACA

By: Daniel T. Desmond

PACA stands for the Perishable Agricultural Commodities Act, a Depression-era federal statute that protects growers and suppliers of unprocessed fruits and vegetables. PACA creates a floating, non-segregated trust on buyer's accounts receivable and inventory. This provides PACA suppliers with a right to payment before all other creditors, including secured lenders with blanket liens. This super-priority status means that when a buyer purchases produce from a PACA supplier, it must account to the supplier before all other creditors. Until the buyer does, the trust operates by placing a lien on not only the inventory derived from the produce , but also on accounts receivable and proceeds from the sale of the produce. 7 U.S.C. 499e(c)(2); In re Magic Restaurants, Inc., 205 F.3d 108, 111-12 (3d Cir. 2000). Since PACA can have harsh consequences for businesses and lenders that deal with PACA suppliers, it is important to be aware of its provisions.

Front-end lenders also need to be mindful of ways in which they can protect their banks and guard against some of PACA's unforgiving provisions.

To establish a PACA trust, the goods in question must be fruits and vegetables which have not been altered from their original state (i.e., cucumbers but not pickles, cranberries but not cranberry sauce, onions but not onion rings). The supplier must also provide the buyer with written notice that the goods are sold subject to PACA, which usually is found on the invoice. Unless the parties agree otherwise, PACA requires prompt payment (usually within thirty days). Buyers who breach a PACA trust may be subject to interest and attorneys fees for collection costs and their principals may be personally liable if they knowingly played a role in dissipating the trust assets (i.e., spending it elsewhere). That is one of the many reasons why it is important to be mindful of accounts involving PACA suppliers.

Perhaps most importantly to lenders, courts have held creditors liable for breach of the trust when they "knew or should have known" that they were being paid with receivables that rightly belonged to the PACA supplier. Consumers Produce Co., Inc. v. Volante Wholesale Produce, Inc., 16 F.3d 1374, 1382 (3d Cir. 1994). In Volante, the court stated that lenders must return the receivables from the PACA trust unless they could prove that they were a bona fide purchaser for value who did not know the receivables came from trust assets. Id; see also Albee Tomato, Inc. v. A.B. Shalom Produce Corp., 155 F.3d 612 (2d Cir. 1998).

In bankruptcy, PACA's impact can be even greater. PACA supplier's claims in bankruptcy enjoy the same super-priority status as they do outside bankruptcy, but they also are not subject to avoidance in a preference action. Courts have held that, since the debtor is holding the funds in question for the benefit of PACA claimants, the funds are not part of the bankruptcy estate. Hence, when the suppliers are paid in full from available trust funds, they are excluded from any new value defense to a preference claim. See In re Arizona Fast Foods, 299 B.R. 589 (Bankr. D. Ariz. 2003). Both the potential lender liability as well as the effects of PACA on a debtor's bankruptcy estate should make creditors mindful of a the PACA trust.

The good news, at least in Pennsylvania's federal courts, is that there is a limit to how far the PACA trust can extend. The trust corpus does not include vehicles and equipment purchased using PACA funds. United Fruit & Produce, 242 B.R. 295, 301. Moreover, real property similarly lies outside the trust since, like equipment, it is not inventory or proceeds from the sale of PACA products. Chiquita Brands Co. N. Am., Inc. v. J & J Foods, Inc., 2004 U.S. Dist. LEXIS 22847, *31-34 (E.D. Pa. 2004). Thus, simply because assets held or purchased by a produce buyer can be traced to PACA trust receivables, it does not follow that those assets are part of the PACA trust. Outside of Pennsylvania, however, courts have found that real property, equipment and even the insurance proceeds of a PACA debtor are subject to the PACA trust. See In re Kornblum, 81 F.3d 280 (2d Cir. 1996); J.A. Besterman Co. v. Carter's Inc., 439 F. Supp. 2d 774 (W.D. Mich. 2006); In re Atlantic Tropical Market Corp., 118 B.R. 139 (Bankr. S.D. Fla. 1990); Sam Wang Produce, Inc. v. EE Mart FC, LLC, 2010 U.S. Dist. LEXIS 13608 (E.D. Va. 2010). It may not be long until the Third Circuit addresses this discrepancy.

So how can a lender wary of PACA protect itself on the front end? The best way is by including a loan provision requiring the debtor to keep a minimum amount, either in reserve or in the form of inventory, to cover eligible PACA claims. That way, the debtor will have funds on hand to cover PACA claimants and the lender will be able to recover from non-PACA assets.

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Homeowners Emergency Mortgage Assistance Program and Act 91 Notice Requirements Officially Reinstate

By: Scott F. Landis

On August 9, 2012, Governor Tom Corbett announced the re-start of the Pennsylvania Homeowner's Emergency Assistance Program ("HEMAP") administered by the Pennsylvania Housing Finance Agency ("PHFA"). HEMAP was discontinued in August of 2011 as a result of PHFA's determination that it lacked the necessary funding for the program. In June of 2012, Governor Corbett signed the Homeowner Assistance Settlement Act. This act, among other things, allocates to HEMAP the lion's share of Pennsylvania's portion of the cash settlement received in the litigation brought by states and the federal government against the nation's five largest mortgage servicers for alleged misconduct in connection with home foreclosures. According to the announcement, Pennsylvania's share of the funds has been received and PHFA will begin accepting applications for HEMAP immediately.

Another important part of HEMAP is the Notice of Intention to Foreclose, also known as the Act 91 Notice (the "Act 91 Notice"), which a mortgage lender is required to send to the borrower before initiating a foreclosure against the borrower's home. The Act 91 Notice provides notice to the borrower of the nature of their default and the time and method to cure such default. It also informs the borrower of HEMAP and how to apply for assistance under the program. The requirement to send the Act 91 Notice was suspended at the time HEMAP was discontinued. As part of the re-start of HEMAP, mortgage lenders will again be required to send the Act 91 Notice before instituting foreclosure in cases where the mortgage is secured by real estate that is the borrower's primary residence. In the August 18, 2012 issue of the Pennsylvania Bulletin, PHFA published its formal notice of the resumption of HEMAP. According to the published notice, October 2, 2012 is the official date for resumption of the Act 91 Notice Requirement. As a result, lenders will not be able to institute foreclosures against a borrower's home, unless it has sent the borrower an Act 91 Notice and has otherwise complied with the Act 91 Notice requirements. The form of Act 91 Notice that is required to be sent is the same form notice that was in effect when the notice requirement was suspended in 2011. A copy of PHFA's published notice, which includes a copy of the form Act 91 notice is attached to this Alert.

One obvious timing question raised by this is how to handle loans that become eligible for foreclosure prior to the October 2, 2012 effective date. If the foreclosure is not filed prior to the effective date, either because it could not be filed (e.g. due to the pendency of another notice period) or for some other reason, the foreclosure will not be able to be filed until the Act 91 Notice is sent and all applicable notice or stay periods have run. This could delay the process for at least thirty (30) days or more. A possible solution to this situation would be to begin sending the Act 91 Notices prior to the date such notices are actually required. Beginning to send the Act 91 Notices no less than 30 days prior to the effective date (i.e., by September 2, 2012) should alleviate the problem of any "notice gap." Also, since PHFA is apparently already accepting applications for HEMAP, lenders may decide to begin sending the Act 91 Notices as soon as possible after publication of the official notification by PHFA.

Sending the Act 91 Notice prior to the actual effective date, as outlined above, will serve two purposes. First, it will make it less likely that a particular foreclosure will fall through the cracks during the transition. Second, it will comply with PHFA's request that lenders give notice to homeowners who are currently in the foreclosure process of the possible availability of HEMAP assistance. Such voluntary notification on the part of mortgage lenders is being encouraged and recommended by some banking and lending organizations as a possible stop-gap to the fear that some courts may unilaterally impose blanket stays on foreclosure proceedings during the transition.

A final area to be discussed involves the inter-relationship between the Act 91 Notice and the notice required under Act 6. The Notice of Intention to Foreclose under Act 6 (the "Act 6 Notice") has been a part of the law since before Act 91. The resumption of requiring the Act 91 Notice does not eliminate Act 6. However, as was the case before the suspension of Act 91, the Act 6 Notice is not required where the Act 91 Notice is being sent. Act 91 expressly states that the Act 91 Notice is to be in lieu of any other notices. The Act 91 Notice also contains all of the information that is required to be included in the Act 6 Notice. For this reason, it seems clear that where the Act 91 Notice is sent no other notice is required, even where the notice is sent before the effective date of the Act 91 Notice requirement. Lenders who are concerned that discontinuing the Act 6 Notice prior to the effective date of the Act 91 Notice requirement could open their foreclosures to a technical challenge, may opt to send both notices during that time period. One other point to keep in mind - Act 6 is not going away. Where Act 91 does not apply, an Act 6 Notice could still be required where: a) the real estate being foreclosed upon meets the definition of "residential real estate" under the act; and b) the original mortgage amount is less than the "base figure" (currently $230,110).

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