

N.Y. COURT OF APPEALS ADDRESS “NOTICES OF LENDING”

- **Lenders Beware - Claimants & Sureties Take Notice**

The relative rights of lending institutions, sureties, owners/developers and lien law trust fund beneficiaries (subcontractors and suppliers) is of critical importance when jobs go bad. Sorting out these rights determine who receives whatever limited funds remain. New York’s highest court has just issued a definitive decision, which should remove any doubt as to the absolute need for strict compliance with the “notice of lending” provisions of New York’s Lien Law.

The court’s decision made clear that it will strictly enforce these provisions, even where other “notice” provisions had been recorded. As will be discussed below, the court’s finding was unequivocal. No Notice of lending - no protection. Recorded construction loan mortgages - even with the requisite Lien Law § 13 covenants for mortgages stating they are subject to the trust fund provisions of the Lien Law - do not provide adequate notice. Worse still, it is now clearly established that the absence of the filing of a notice of lending leaves a lending institution liable for a claim of trust fund “diversion” when it “pays itself back” with trust fund assets its own construction loan had created.

The notice of lending filing provisions in New York’s Lien Law promotes the legislative intent of providing public notice of any transaction by the owner, contractor, subcontractor or any other party that may lead to depletion of funds available for future trust claims. Such record notice provides persons who furnish materials or services in reliance on the trust assets receivable by the trustee at later stages of the improvement, notice that those assets have been anticipated for a current expense.

The case before the Court of Appeals involved a construction loan utilized on a New York City Housing Authority (NYCHA) project in Brooklyn for the renovation of residential buildings. The plaintiffs alleged in their complaint that they were owed monies on their subcontracts and that the construction loan lending institution had diverted trust funds by repaying itself prior to paying plaintiff’s claims for work performed and material provided. The bank countered in its answer that it was “not a statutory trustee and the funds paid to itself did not constitute trust assets” and, furthermore, that plaintiff’s claims were barred by virtue of the banks “superior mortgage interest.” The bank maintained, its repayment was permissible

because it used the money to pay its properly recorded, secured loans, which were superior to plaintiff's claims pursuant to the Lien Law's statutory priority provisions.

However, it's well established that the primary purpose of Article 3-A of the Lien Law is designed "to ensure that those who would directly expend labor and materials to improve real property (private or public) at the direction of the owner or general contractor receive payment for the work actually performed." Funds that are received by the owner under building loan contracts and building loan mortgages are unquestionably trust assets. Trust assets require owner-trustees to apply trust assets to payment of the cost of improvement including "expenditures in paying the claims of a contractor, architect, engineer, surveyor, subcontractor, laborer, materialmen... and sums paid to discharge building loan mortgages whenever recorded." The use of trust assets for a non-trust purpose is deemed a "diversion" of trust assets, whether or not there are trust claims in existence at the time of the transaction.

The Lien Law incorporates a mechanism for trustees to alert beneficiaries to the distribution of trust assets in repayment of advances made by lenders. Trustees or lender-transferees must file a "notice of lending" to protect the lender's right to repayment from trust funds.

The court also pointed out, significantly, that a proper filing of a "notice of lending" is an affirmative defense to any lawsuit charging a trustee with a diversion of trust assets or an action to recover diverted assets from a transferee (such as a bank receiving repayment of its loan). In any action against a trustee-bank, the notice of lending evidences that the alleged diversion was properly made in repayment of advances made by the bank as trustee and that such advances were actually applied for a legitimate trust purpose, repayment of a recorded building loan mortgage.

As a statutory trustee, the bank was obligated to “act as a fiduciary manager” over funds. The bank owed the beneficiaries a duty of loyalty as a trustee and was required to administer the trust solely in the interest of the beneficiaries. The court held that, without a notice of lending, the bank’s use of trust assets to repay its own loans on the project - without acknowledging its status as trustee or providing notice to trust beneficiaries of the transfer - constituted a breach of its fiduciary duty. The court specifically observed that the bank’s recorded filing of its loan agreement and construction loan mortgages were to no avail. Although its recorded construction loan mortgage gave potential trust beneficiaries notice of the bank’s claim priority as a secured mortgage lender, nothing in the mortgage documents identified the bank as a trustee of Article 3-A assets. Thus, without a proper filing of a notice of lending, the bank, as a trustee, would be “guilty” of self-dealing since it was both a trustee as a recipient of funds and a trust fund beneficiary as an entity with a claim against the trust funds for repayment of its loan. Conversely, if it had filed a proper notice of lending, the bank would have eliminated any taint of self-dealing in repaying its own loan and the beneficiaries would have been properly apprised of the fact that, (1) the trust assets were being depleted in order to repay the recorded loan documents, and (2) the bank was a trustee acting as both transferor and transferee of those funds.

G&C Commentary

The message of this decision is clear - **CAVEAT LENDER**. The court’s interpretation was as strict as its wording clear. One of the first things properly advised Lien Law claimants should look for on jobs that have gone bad is a recorded notice of lending for each construction loan advance on the project on which they are making a claim.

One final point B the Court of Appeals declined to address the damages caused by the bank’s breach of its fiduciary obligation since there was an agreement among the parties on this issue. However, it pointed out that the lower court had ruled that the bank’s repayment to itself invalidated its statutory priority as a secured mortgage lender and rendered the bank liable to plaintiffs for the full amount of any transferred trust assets or “diversion.” The bank had to disgorge any trust assets made in repayment to itself and to first make such funds available to trust fund beneficiaries.

Words: 1133

