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EAB Plaza
Uniondale, NY 11556-0120
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Construction Finance Business Advisory

By Andrew L. Crabtree

LENDER LIABILITY UNDER NEW YORK'S LIEN LAW

Lender Liability for "Trust Fund" Diversion of Owner-Assigned Sale Proceeds Used To Satisfy Loan

In *Aspro Mechanical Contracting v. Fleet Bank*, 742 N.Y.S.2d 361 (2d Dep't 2002), the Appellate Division, Second Department, recently held that a lender who takes an assignment of a contract to improve and convey property as security for a building loan can be held liable as a Lien Law trustee for subcontractor claims if it receives direct payment of the sale proceeds, pursuant to the assignment, and applies those proceeds to repayment of the loan it made to the property's owner.

In *Aspro*, the owner-contractor, Berry Street Corp. ("Berry Street"), contracted with the New York City Housing Authority ("NYCHA") to acquire certain property in Brooklyn, improve that property with residences, and then convey title of the improved property to NYCHA. Defendant's predecessor in interest, Norstar Bank, made building loans to Berry Street, taking back mortgages. The mortgages indicated that they were subject to Lien Law § 13 and were recorded, as was the building loan agreement pursuant to Lien Law § 22¹. As additional security for the building loan, the lender took assignment of all Berry Street's "right, title and interest in, to and under" its contract with NYCHA. Later, when title was conveyed to NYCHA, the proceeds of the sale went directly to the lender, which applied those proceeds to the repayment of the loan it had extended Berry Street.

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- ¹ Lien Law §13(3) provides that "[e]very such building loan mortgage . . . shall contain a covenant by the mortgagor that he will receive the advances secured thereby and will hold the right to receive such advances as a trust fund to be applied first for the purpose of paying the cost of improvement" A building loan mortgage containing this covenant, and filed in accordance with §22, has priority as to advances made by the mortgagee before lien filing. Lien Law §13(2).
 - ² See *Matter of RLI Ins. Co. v. New York State Dept. of Labor*, 97 N.Y.2d 256, 263 (2002) ("[L]ien Law article 3-A mandates that once a trust comes into existence its funds may not be diverted for non-trust purposes.")

The plaintiff, subcontractors who had not been paid, argued that, by virtue of the assignment, the lender became a statutory trustee under Lien Law article 3-A, and that its use of the sale proceeds to repay the loans was an improper diversion of trust assets of which the subcontractors were beneficiaries.² While the lender argued that it did not become a statutory trustee because the purpose of the assignment was to secure the loan, the court held that "the effect of the assignment, however, was to entitle the bank to direct payment of the proceeds of the sale, which, absent the assignment, would have been paid to Berry Street Corp., and been subject to the trust provisions of Lien Law article 3-A".³

Thus, the court held, the lender's rights were no greater than those of Berry Street, as assignor, whose rights were subject to those of the subcontractors, as beneficiaries of the statutory trust. The court further held that the bank "could only defend that the transfer of trust assets were made to repay advances made by it, and that such advances were used for a trust purpose, if a Notice of Lending had been filed" pursuant to Lien Law §73.⁴

The Notice of Lending was essential because the plaintiffs did not sue as mechanics lienors, but as trust fund beneficiaries and claimed a diversion of trust funds. Generally, the lender's compliance with Lien Law §§13 and 22 would have given the mortgage priority over subsequently filed mechanic's liens, but priorities are irrelevant on a diversion claim. While the opinion can be criticized on the grounds that the transferred payments did not make the bank an article 3-A trustee,⁵ and that the application of those funds to pay off an existing building loan mortgage, i.e., a "cost of improvement," was not a diversion of trust funds,⁶ any assignment of what may arguably constitute trust funds should certainly be accompanied by a Notice of Lending.

3 *Aspro Mechanical Contracting v. Fleet Bank*, 742 N.Y.S.2d at 363; see Lien Law §70 ("funds . . . received by an owner for or in connection with an improvement of real property in this state . . . shall constitute assets of a trust").

4 *Id*; see Lien Law §73 ("In any action against a person to whom trust assets have been transferred . . . a transferee named in a 'Notice of Lending', . . . shall be entitled to show, by way of defense, that the transfer was made as security for, or in consideration of, or in repayment of advances made to, or on behalf of, the trustee. . .").

5 See Lien Law §70(1) (defining trust funds as those received by owner, contractor or subcontractor).

6 See Lien Law §71(1) (the assets of Article 3-A trusts "shall be held and applied for payment of the cost of improvement.") and §2(5) (expressly defining "cost of improvement" as including "sums paid to discharge or reduce the indebtedness under mortgages and accrued interest thereon and other encumbrances upon real estate. . . , sums paid to discharge building loan mortgages whenever recorded.").

Andrew L. Crabtree
516.227.0619
acrabtree@farrellfritz.com



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EAB Plaza
Uniondale, NY 11556-0120
(516)227-0700
(516) 227-0777 facsimile
ffmail@farrellfritz.com
www.farrellfritz.com

