

Owners Could Pay Twice Under the New Jersey Construction Lien Law

By: Sarah B. Biser¹

If there were any doubts about which of two innocent parties bears the financial burden caused by a defaulting contractor under the New Jersey Construction Lien Law ("CLL"), N.J.S.A. 2A:44A-1 to 38, the New Jersey Appellate Division recently clarified the issue. *Emory A. Craft, Jr. v. Stevenson Lumber Yards, Inc.*, (App. Docket No. A-3126-01T3). Here, the Court held that a property owner's obligation to a lienor-subcontractor is the difference between the contract price and the amount already paid to the general contractor — even if that calculation results in the owner having to pay more for the completed job than the original contract price.

Craft contracted with Aladich Builders for the construction of a residence for the total cost of \$220,000. Aladich bought supplies from Stevenson Lumber Yard and Dubell Lumber Company. Aladich had several construction projects ongoing at the same time and did not request that its suppliers establish separate accounts to reflect each of the various projects that Aladich was working on. Aladich maintained a balance on an undifferentiated account with Stevenson. When Aladich made payments to Stevenson, Stevenson simply applied the payments to the oldest outstanding Aladich invoice.

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Identifying Construction Appraisal Risk in the Mortgage Portfolio

By: Mark Chapin, IFA FNIS Hansen Quality²

Risk in the Seller's and the Construction Market

As seems evident, the residential real estate market has recently continued its several-years-long journey into the seller's and construction market arena spurred by appreciating real estate values. As magnificent is this reality, the market for sellers or lenders originating construction loans is not without risk. The most widely recognized risks in this kind of market are transactional fraud, significantly inflated property values, and



the ability to properly evaluate plans and specifications for a construction project. There are other, less obvious, risks buried in the strong market that can sometimes be camouflaged by the surge in appreciating values, such as a property's "misfit" in its market place due to its architectural design or size. Identifying inherent risk is important even in the strongest market.

In discussions with Richard W. Nirk, the Executive Director for the National Association of Residential Construction Lenders (NARCL), I have reviewed concerns that a majority of lenders have expressed in evaluating and monitoring their construction appraisal area. The issues cited above are examples of the daily operational issues each construction lender has faced, and as this market grows, need to be aware of to ensure continued success.

Identifying Risk Factors for Construction and Overall Markets

It is difficult to argue with the proposition that the ability to look at and analyze important risk factors (and to accurately measure the effect of risk) helps ensure that mortgage bankers, construction lenders, investment bankers, insurers and others involved in the residential real estate market make sound loans and evaluate and understand overall risk. Accurate identification and analysis of important valuation factors are indispensable to this task.

Evaluating risk may take into consideration factors such as the location of the subject property within its community and immediate neighborhood. Adverse influences may be evident by proximity to industrial/commercial concerns, noise (e.g., busy streets, nearby freeways or flight paths), and perhaps other "environmental" issues such as weather, light and terrain. Issues such as over improvement and location can also be critical in evaluating effect on construction projects.

The "fit" of the subject into its market place may likewise impact risk. Architectural up-fit issues such as floor plan, exterior and interior design, and acquisition price as compared to

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² Mark Chapin, IFA, is a veteran real property valuator and trend analyst working in business development at FNIS Hansen Quality, the nation's premier provider of collateral assessment solutions. FNIS is a majority-owned subsidiary of Fidelity National Financial (FNF); the largest title insurance and diversified real estate related Services Company in the nation. Mark Chapin may be reached at (858) 243-6698 or email at mchapin@hanqual.com.

Owners Could Pay Twice (cont'd)

By the time plaintiff Craft had paid Aladich \$166,980 on the contract, Aladich walked off the job. Aladich owed approximately \$75,000 to Stevenson and \$7,500 to Dubell. Both Stevenson and Dubell filed notices of unpaid balances and right to file liens under N.J.S.A. 2A:44A-20 and lien claims against Craft's interest in the property under N.J.S.A. 2A:44A-3 and -10.

Both Craft and Dubell filed suit, the matters were consolidated, and motions were made for summary judgment. The trial court found that a lien fund existed in the amount of \$53,020, which represented the difference between the \$220,000 contract price and the \$166,980 that Craft had paid Aladich. The Appellate Division affirmed.

Craft, the owner, had argued that no "lien fund" existed because it had paid Aladich for the work it had completed, even though Craft had not paid the full contract price. The Court agreed that under the prior lien law Craft's position would have been correct. However, the Court cited a Supreme Court case, *Thomas Group, Inc. v. Wharton Senior Citizen Housing, Inc.*, 163 N.J. 507 (2000), which held that the history and wording of the CLL demonstrated a purpose to strengthen the rights of lienors.

The Court said that decisions interpreting the old lien law did not apply to the CLL, citing its decision in *Legge Indus. v. Kushner*, 333 N.J. Super. 537 (App. Div. 2000) and *AEG Holdings L.L.C. v. Tri-Gem's Builders, Inc.*, 347 N.J. Super. 511 (App. Div. 2002). In *AEG*, the Court held that the "property owner's lien obligation to a subcontractor [constitutes] the difference between the contract price and the amount already paid to the general contractor, even though that resulted in the owner having to pay more for the finished job than the original contract price."

Further, the court stated that these holdings are consistent with the CLL, which provides that the limits of a property owner's liability vis-à-vis a subcontractor or supplier is the lesser of the "what remains unpaid on the prime contract or on the amounts owed the subcontractor or supplier."

The Court also found that, generally, the creditor's choice of payment application will stand as long as a debtor does not direct specific application of payment. Having received no direction for application of the Aladich payment, Stevenson chose to apply the payments to the oldest outstanding invoices. This method of applying payment proved detrimental to Craft who most recently had received supplies from Stevenson at the direction of Aladich.

One additional lesson: strict compliance with the CLL is required in order to claim the benefit of its provisions. Craft argued that Stevenson's suit should be dismissed because Craft served a notice demanding that Stevenson foreclose on its lien and Stevenson did not timely comply. Craft's purported demand to foreclose, however, was not served by personal service or by certified mail, return receipt requested and did not specifically or clearly require Stevenson to institute litigation to establish its lien claim, as mandated by the statute. The Court required strict compliance and refused to dismiss the lien claim.

Postner & Rubin Note

In *Craft*, the Appellate Division has cleared any doubt that may have existed after *Legge* and *AEG* regarding the vulnerability of a property owner under the CLL. In *Legge*, the Court held that a private owner's use of the retainage to make post-lien-payment to a successor contractor does not reduce the lien fund. In *AEG*, the Court expanded upon *Legge* by stating that a property owner's maximum liability vis-à-vis a subcontractor is the lesser of what remains unpaid on the prime contract or on amounts owned to the subcontractor or supplier, prior to receipt of the lien claim. The implication to be drawn from *AEG* was that a "contract balance" is calculated by subtracting the amount paid from the contract price, not by subtracting the amount paid from the amount actually earned under the contract. After *Craft*, there can be no doubt. The CLL protects contractors and suppliers to the detriment of a property owner who may have to pay more for the finished job than the original contract price. As the *Craft* Court stated, property owners unhappy with this state of affairs should express their view to the State Legislature.

Developments with NARCL

By Richard W. Nirk³

The National Association of Residential Construction Lenders (NARCL) provides education, information, and is devoted to developing procedural standards for the benefit of the construction lending industry. The group is comprised of borrowers, lenders, builders, investors, and other professionals in the residential construction lending community. Some of this year's highlights include the following:

Key Developments

- **Builder Education** — NARCL has developed an educational program on behalf of lenders that directly benefits the builder. This program is designed to outline the various

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³ Richard W. Nirk has over 20 years of commercial, construction and mortgage lending experience. He has been employed by a number of firms such as CitiGroup and American Express, and for many years was the National Construction Product Manager for Chase Manhattan Banking Corp. He currently is the Executive Director for the National Association of Residential Construction Lenders and is a National Construction Advisor for the Excell Management Group, Ltd.

Identifying Construction Appraisal Risk in the Mortgage Portfolio *(cont'd)*

the overall neighborhood should be considered. Analyzing economic factors may help define risk, too, both from a macro and microeconomic perspective. Unemployment rates, median income levels, and even an analysis of the available supply of buyers for a given house in a given neighborhood assist in the understanding of risk. Identifying that a particular market area is appreciating, stable or depreciating and forecasting these trends are important to the risk equation, too.

The identification of these and other factors helps in the assessment of inherent risk in collateral. For construction lending consider the following three areas that appear to be of considerable concern:

- **Ability of the Appraiser to Evaluate Plans and Specifications.**

The number one question and concern according to our panel of construction lenders is addressing the idea of whether or not the appraiser can properly evaluate plans and specifications. Interestingly, of all the recognized courses developed for appraisers that enhance their ability to accurately derive value, very few instruct on how to read and interpret blueprints. Thus, many appraisers are subject to missing important structural, site, and component item considerations due to a lack of understanding of the architects or draftsman's iconic renderings. When engaging an appraiser it is wise to ask if they have been schooled in the reading and interpretation of plans and specs. While education is not plentiful, excellent courses are available from organizations such as The Appraisal Institute and The National Association of Independent Fee Appraisers. As Certificates are issued evidencing course completion by both institutions, it may be prudent for a lender to request a copy as part of their due diligence process.

- **Fit of the Subject Property Into Its Marketplace.**

The second most common concern according to construction lenders involves a home's potential fit into its overall environment or marketplace. Will the architecture of a new or infill project or major renovations in a gentrification project appeal to the masses or has a

"white elephant" been created? In my 20+ years in the residential valuation field, I have many times counseled both purchaser and lender of this ubiquitous item. It is important to realize the parameters of a neighborhood in both economic and architectural terms.



Thus, the \$200,000 renovation project in a neighborhood of \$150,000 homes may produce limiting market returns no matter how high the quality and appeal of the job is to the current owner.

- **Evaluation of Comparables.**

Identification of proper market data is also a common concern of construction lenders. In larger new home projects, comparable sales are generally plentiful, but what about the new construction infill house, the first few homes in a new subdivision surrounded by older existing houses, or the renovation project? In these situations it is important to engage an appraiser that has a good sense of the overall market area being considered and the ability to identify submarkets within existing markets. All too often, an appraiser that falls short in these areas will either be unable to produce a credible report or provide data that is not relevant to the issue at hand. Asking a few questions, or utilizing a supplier that prescreens its valuers, will save many headaches.

- **Total Construction Project Cost vs. Appraised Value.**

This is another item that should be carefully examined when considering loan to value issues. How close together are cost and value estimates? Will the projected appraised value cover the cost of the project, inclusive profit wants, and future returns? Careful review of the appraisal report should include a scan of the appraiser's estimate of construction costs. A common mistake in appraisal reporting is the accidental noninclusion of "margin" in this part of the estimate. This is just another justification for utilizing an appraiser with a good understanding of the difference between the appraisal of existing and new improvements.

One additional item in this area is the use of Appraised Value over Project Cost. Many construction lenders today have credit policies that require LTV calculations based on the lower of Project Cost or Appraised Value. There is certain circumstances, usually involving renovation where the higher of the two (if the higher is Appraised Value) can be appropriate. Renovation can provide value enhancements, which are quite positive, and this is something the lender will need to carefully evaluate with its appraiser or appraisal organization.

- **Benefits of a Good Appraiser Review Process.**

At this point it should be apparent that having a good appraiser review process for any aspect of real estate lending is important. Construction lending can be a very important part of a lender's overall portfolio, but it should be understood that the evaluation of collateral to be constructed or renovated carries a higher level of risk. Understanding your appraiser's capabilities in the area of construction lending will provide not only good risk management, but give the lender the ability to grow this type of product.

Developments with NARCL (cont'd)

credit options available to the builder, which includes everything from builder credit lines to construct-to-perm lending. A recent presentation was given at the South Eastern Builders Conference (SEBC) to wide acclaim and will also be presented at the upcoming National Association of Home Builders (NAHB) Show in 2004. NARCL also plans to further promote the program by contacting various large metro-area Home Builder Associations (HBA) throughout the country, in order to also provide this educational program on a local level.

- **Builder (Contractor) Information Questionnaire** — After some concentrated research with various builders throughout the country, it was determined that one of the most common issues frustrating builders nationwide was the inconsistency of standards with the lender community. When a consumer obtains a construction loan or if a builder applies for credit, the builder on the project is often reviewed based on his/her qualifications and creditworthiness. The application process, however, can vary from lender to lender. Therefore, NARCL has developed a standardized Builder Informational Questionnaire that can be used by all members of the residential construction lending community. The Questionnaire will be available to any construction lender by late 2003.

If you would like more information about NARCL, our regular membership conference calls, programs available and/or activities, please contact Richard W. Nirk at www.rwnirk@narcl.org.

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Construction at a Glance

	Sept. 03	Sept. 02
Monthly Housing Starts*	1,880	1,449
Permits-Single Family*	1,099	1,008
Monthly New Home Sales*	1,145	1,057
Unemployment Rate	6.1%	5.7%

**Thousands of Units*

10770 E. Briarwood Ave.
Suite 280
Centennial, CO 80112

