Introduction to the New York Lien Law for Counsel to Owners of Troubled Construction Projects
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A substantial commercial construction project (a “Project”) can go wrong in many ways. One common way occurs when the general contractor (the “GC”) becomes insolvent or otherwise trips and falls and cannot finish the project. When that happens, the owner of the Project (the “Owner”) will find itself in an awkward corner, potentially facing claims from parties that Owner didn’t even know existed.

When an Owner engages a GC under a traditional general contract, that GC agrees to build the Project for a fixed fee1 and pay all subcontractors and material suppliers (collectively, “Vendors”2). At any point during the Project, however, GC may drop the ball as suggested above, or may default in other ways. In a perfect world, i.e., in an Owner’s fantasyland, GC will at that point have paid all its Vendors everything due them. GC will have funded these payments from money that Owner gave GC to pay for the Project.

More likely, however, GC will not be current in paying Vendors. To the contrary, GC’s problems will usually also lead to delayed Vendor payments. GC will have used funds from this Project to pay other debts or clean up similar messes on previous Projects. Or those payments may have funded home theater systems, birthday parties, and cruises in the Caribbean and elsewhere.3

Owner will derive cold comfort from the fact that GC remains liable to unpaid Vendors. As a practical matter, unless someone pays Vendors, they won’t keep working. Although Owner could conceivably finish the Project with replacement Vendors, that process will cause huge disruptions and delays. Moreover, Owner will find some Vendors so vital that Owner cannot replace them.

In New York, Owner may also face direct claims against the Project and the real property on which it sits (together, the “Site”) from unpaid Vendors, as a result of New York’s “floridly complicated and impenetrably opaque”4 Lien Law (the “Lien Law”). The Lien Law gives Vendors two possible ways to make claims against Owner or the Site, in addition to any direct contractual rights that any particular Vendor can assert.5

First, Lien Law Article 2 (“Article 2”) allows an unpaid Vendor to file a mechanic’s lien against the Site (a “Lien”) and enforce that Lien.

Second, Lien Law Article 3-A (“Article 3-A”) creates a separate trust fund regime to protect GCs and Vendors. Article 3-A makes Owner a statutory trustee over certain funds available for a Project. If Owner diverts assets from that trust, then Owner may incur liability to any Vendors that hold Liens or contracted directly with Owner.6

Owner will want to minimize its Article 2 and Article 3-A exposures if a Project goes bad, whether because of GC default or bankruptcy or otherwise. Owner will also want to: (1) complete the Project; (2) do so on time; and (3) do so on budget. As a practical matter, Owner will count itself lucky to achieve even the first goal if GC gets into trouble. But the strategies suggested here may help Owner achieve the best possible outcome under the circumstances.

As always, the legal rights, obligations, analysis, and strategy for any Project will depend on the facts and circumstances of that Project. That holds particularly true for the Lien Law. Application of the Lien Law to any set of facts usually amounts to a difficult exercise, given: (a) the opacity of the Lien Law; (b) the limited scope of cases interpreting the Lien Law; (c) the fact-intensive nature of the scant case law that does exist; and (d) the history of surprises in this area, particularly in Article 3-A.7

Thus, although this article seeks to offer a general roadmap, any Owner or its counsel must fully understand the facts and think through the law that applies to them, and not rely on this summary. This article offers only a rudimentary introduction to the Lien Law, and only from an Owner’s point of view.

I. Owner’s Obligations Under the Lien Law

This article first summarizes an Owner’s exposure under Article 2, then turns to Article 3-A. It does so for three reasons, all discussed at greater length below:

1. Article 2 Lien claims have priority over Article 3-A trust claims. Article 3-A expressly blesses the use of “trust assets” to pay Liens,8 and imposes extra liability on an Owner that applies Article 3-A trust funds to make payments that violate Article 2 priority rules for Liens.9

2. The Article 2 priority rules restrict an Owner much more than comparable rules under Article 3-A.

3. Owner must therefore figure out how to contend with its Article 2 obligations before it figures out how to deal with Article 3-A.

This discussion focuses primarily on Owner’s Lien law problems. For a typical Project, of course, most of the money will come from a construction lender. In some ways, a lender’s issues will overlap Owner’s. The Lien
Lien’s requirements for a “building loan contract” will, however, compound a lender’s headaches. This article does not cover the special concerns of a construction lender.10

A. Owner and Article 2

If a Vendor files a valid Lien under Article 2, Owner will need to pay that Lien or figure out how to get rid of it. If Owner doesn’t, then eventually the Lien holder can foreclose its Lien and force a sale of the Site. In the meantime, so long as a Lien remains in place, Owner may find the Site unsaleable and unfinanceable. Often, Owner cannot proceed with the Project either, because Owner’s lender will refuse to fund further advances.

Article 2 contains two sets of rules that Owner must understand.

First, Article 2 defines how much a Vendor can expect to successfully claim on its Lien. As against the rest of the Lien Law, these provisions are relatively comprehensible.

Second, Article 2 defines the priorities an Owner must follow if it wants to pay multiple Lien holders. These rules limit Owner’s freedom to play favorites in paying Lien holders.

1. Owner’s Liability to Mechanic’s Liens

In general, Owner faces exposure for the amount a Vendor claims in a Lien only to the extent that: (a) the Lien is valid; (b) the Lien holder’s claim represents a reasonable estimation of the amount owed, and, (c) Owner still owes money to GC. If the Owner does not owe money to GC when a subcontractor files a Lien, but an open balance later arises, the Lien will attach only to the after-arising “Lien Fund.”11

First, Owner is only liable to a Lien holder if the Lien is valid. To obtain a valid Lien, the claimant must: (a) follow numerous technicalities to properly file the Lien,12 and (b) meet three substantive conditions in Lien Law Section 3. Those three substantive conditions are:

a. Vendor must fall within a certain class of persons that provide materials or services that improve property, which includes contractors, subcontractors, laborers, and material suppliers;13
b. Vendor must have “permanently” improved Owner’s real property,14 and
c. Owner, or its agent (who can be GC or some other Vendor) must have requested, or at least consented to, the improvement.15

Second, even if the Lien is valid, Owner faces exposure only to the extent of the unpaid balance due the Lien holder when it filed its Lien.16

Third, Vendor must have “substantially performed” its contract before it can collect what it is owed under its contract.17 Otherwise, the Vendor can recover only in “quantum meruit.” Although the measure of damages based on “substantial performance” consists of the contract price less the cost of completion, the measure of damages in “quantum meruit” consists of the fair value of its work—measured not by the contract balance, but instead by the reasonable value to Owner of Vendor’s labor and materials.18

A court will generally hold that Vendor has “substantially performed” if Vendor can demonstrate that it “has in good faith intended to comply with the contract,” and has substantially done so.19 Thus, if Vendor’s work contains slight defects or deviations from the plans, it can still collect the unpaid balance of its contract minus any damage that resulted from defects or deviations.20 If, however, Vendor’s work is somewhat significantly incomplete or defective—even, e.g., to the extent of as little as five percent of the total value of the contract—a court may decide that Vendor has not “substantially performed.”21 As in so many areas of the law, and particularly the Lien Law, much depends on the particular facts and circumstances and how a specific court decides to view them.

The doctrine of “substantial performance” applies a little differently to an “installment contract,” a contract structure often seen in construction. Here, Vendor accepts payments in installments based on Vendor’s completion of specified tasks. An installment contract might say, for example, that Vendor will receive a percentage of the contract based upon completion of each floor in a multistory building. Vendor will be entitled to payment under its contract to the extent it has “substantially performed” each installment even if it has not “substantially performed” the entire contract.22 Thus, if Vendor has substantially completed two of five floors, it will be entitled to the contract price for only those two floors. For the other three floors, Vendor will be limited to “quantum meruit”—at least until Vendor substantially completes each of those three floors.

The doctrine of “substantial performance” should not be confused with the concept of “substantial completion” in many construction contracts.23 The American Institute of Architects (“AIA”) form construction contract defines “substantial completion” as the stage in the Project when “Owner can occupy or utilize the [w]ork for its intended use.”24 Put another way, the AIA’s version of “substantial completion” occurs at the point when Owner can take beneficial occupancy of the work.

A construction contract will often require Vendor to demonstrate “substantial completion” as a condition to payment, or at least as a condition to the final payment.25 The contract may also require Vendor to obtain a certificate from the architect stating that the work has been completed in accordance with the terms and conditions of the contract, as a condition precedent to payment.26 Where a certificate is required, a Lien will not be enforced without such certificate, unless Vendor can demonstrate that it was unreasonably withheld.27
As a fourth limitation under Article 2, Owner’s liability to Lien holders cannot exceed the total amount Owner owes GC. Each Vendor essentially steps into the shoes of GC in asserting claims against Owner (in effect becoming “subrogated” to GC’s claims against Owner), and those claims cannot exceed whatever claims GC could assert against Owner. As a result of this principle of subrogation, Owner owes Vendor only the lesser of:

a. Whatever GC owes Vendor when Vendor files its valid Lien, and

b. Whatever Owner owes GC when Owner receives notice of filing of that Lien.

Similarly, if Vendor has contracted out part of its contract to some other Vendor (a “Sub-Vendor,” typically a subcontractor), Sub-Vendor becomes subrogated to Vendor’s rights. Thus, Sub-Vendor’s Lien is valid and enforceable only up to the amount, if any, still due and unpaid to Sub-Vendor from GC. If no funds are due, Sub-Vendors are relegated to their trust fund rights.

Where GC owes Vendor funds, Owner would then owe Sub-Vendor the lesser of:

a. Whatever Vendor owes Sub-Vendor when Sub-Vendor files its valid Lien,

b. Whatever GC owes Vendor when GC receives notice of filing of that Lien.

These “subrogation”-based limits are also subject to the requirements for “substantial performance” discussed above. If, for example, GC has not “substantially performed” under its contract, then Vendor Lien holders will see their claims capped at GC’s “quantum meruit” damages, if any, instead of as described in subparagraph “b” of the two preceding formulas.

2. Priorities Under Article 2

If Owner must pay one Lien holder, Owner will probably find it must pay many. If so, it will need to navigate the complicated and perilous Article 2 priority rules. These priority rules should, however, not be relied upon as written. They are nuanced, have been heavily litigated, and the Lien Law gives courts plenty of authority and latitude to fashion remedies as they see fit. For context, an action to enforce a Lien takes the form of an action to foreclose a mortgage. This means that the action is one in equity. Against that backdrop, Owner must proceed with great care.

Article 2 priority rules do not follow the “first-to-file” priority rules that typically apply in real property law. As among Lien holders claiming from the same Project, order of filing does not matter. Instead, Lien holders will be treated the same regardless of when they filed, with two important exceptions. First, if a Vendor does not file until after an earlier filed Lien has been discharged, the late filing Vendor will lose any rights to whatever Owner paid the Lien holder who filed first. Second, if a Vendor does not file until after Owner has conveyed the property under a recorded deed containing the statutory covenant provided by Lien Law § 13(5), that Vendor will not be treated the same as those Vendors who filed before the conveyance.

The Lien Law sets four priorities as among valid Liens in a foreclosure action under Article 2:

1. Laborers for daily and weekly wages;
2. Sub-Vendors;
3. Vendors that directly supplied GC; and finally
4. GC and other parties with whom Owner has contracted directly.

Within each priority level, multiple Lien holders have “parity,” meaning they each take a pro rata share in proportion to their claims. Where a single contract covers more than one building, each Vendor should have a priority claim on the part of the real property or the particular building where such Vendor’s labor was performed or such Vendor’s materials were used.

If Owner disregards these statutory priorities and chooses to pay certain favored Vendors first, Owner should not face significant penalties. Lien Law § 56 recognizes and permits voluntary payments of any Lien. Although payments made under Lien Law § 56 to certain Vendors do not diminish the Lien of other Vendors, practically speaking, the payments work to reduce the overall Lien fund. First, most construction contracts will reduce the contract price payable to GC when Owner pays Vendors and Sub-Vendors directly. Second, GC will not be able to include the amount of the Lien Law § 56 payment to Vendor or Sub-Vendor in its Lien claim.

Because Lien Law § 56 does not expressly limit an Owner’s liability, a court could conceivably frown upon—and impose liability on account of—payments that an Owner makes to favored Vendors without regard to Lien priority rules. No available case considers that specific question.

B. Owner as Statutory Trustee Under Article 3-A

Above and beyond Liens arising under Article 2, Lien Law Article 3-A establishes an entirely separate legal regime. Under this system, Owner can automatically become a statutory trustee to hold certain “trust assets”
for the benefit of certain Vendors known as “trust beneficiaries.”

These “trust assets,” as provided for in Article 3-A, include funds that Owner receives in connection with an improvement of real property. Funds that do not originate from any of the seven sources described in Article 3-A are not “trust assets.” For example, Owners own invested equity capital does not constitute a “trust asset.”

Although any Owner may find Article 3 a greater nuisance than Article 2, Article 3-A is, as a substantive matter, not nearly as onerous as Article 2. Usually, Owner will not owe any Vendor more under Article 3-A than Owner owes the same Vendor under Article 2. Article 3-A also usually allows an Owner to pick and choose which Vendors to pay first, but subject to one crucial caveat. If Owner violates the very limited priority rules in Article 3-A, Owner can face severe consequences under New York Penal Law. It’s a crime!

1. Owner’s Liability to Vendors

Owner’s potential liability under Article 3-A is staggering broader than under Article 2. Owner will, however, rarely owe Vendors more under Article 3-A than under Article 2.

Owner potentially owes Vendors the entire amount of Owner’s “trust assets,” which consist of certain funds Owners has received or is due to receive to complete the Project. Owner’s “trust assets” include its construction loan proceeds plus any availability—including future availability—under the construction loan. The “trust assets” in Owner’s hands could also include other funds Owner received, or Owner’s rights of action for payment of funds in connection with the Site. Owner should note that if a single construction loan agreement governs the entire Project, this will create a single pool of “trust assets,” even if multiple notes and mortgages exist. If multiple construction loan agreements govern different pieces of the Project, multiple pools of “trust assets” will exist.

From this large pool of “trust assets” under Article 3-A, however, only a certain limited class of Vendors will actually have the right to make claims as “trust beneficiaries.” Lien Law § 71(4) defines “trust beneficiaries” as Vendors that hold valid “trust claims.” Most Vendors will, however, rarely have valid “trust claims” against Owner. That is because, under Lien Law § 71(3)(a), for the trust where Owner acts as trustee, “trust claims” means only “claims of contractors, subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, for which the owner is obligated.” Under New York law, Owner is “obligated” only to those Vendors that are in privity of contract with Owner or that have actually obtained valid Liens on the Site. In the typical case, Vendors who are “trust beneficiaries” have obtained valid Liens, so their “trust claims” simply consist of whatever they can claim under Article 2. Sub-Vendors who are not in privity of contract with Owner—hence unable to claim against “trust assets” held by Owner—may still have valid “trust claims” against the GC or other Vendors who have received “trust assets.”

2. Article 3-A Priority Rules

Owner can pay favored Vendors first out of the “trust assets”—even if those Vendors are not themselves “trust beneficiaries”—if Owner follows a few simple rules.

Owner can pay any Vendor claim for a cost of improvement, and can apply any “trust asset” among Vendors as Owner chooses, so long as a court has not directed Owner to make particular payments of “trust assets.” A court will probably direct payments only if it finds that Owner has diverted “trust assets.” Owner can avoid diverting “trust assets” by following two precautions.

First, Owner cannot use “trust assets” for any purpose except the purpose of the trust. Virtually every payment Owner would want to make for the Project will probably meet that test, given that Lien Law § 71 defines the “purpose of the trust” as “payment of the cost of improvement.” Courts have occasionally found that a few Project-related payments an Owner might want to make would flunk that test, such as refunds to Owner for emergency advances, corporate administrative costs, and attorneys’ fees. Despite occasional exceptions like these, the “purpose of the trust” remains quite broad.

Second, Owner must keep records on the inflow and outflow of “trust assets”—failing which, a court can decide that Owner has “diverted trust assets.” Any diligent Owner can usually satisfy these recordkeeping requirements, though, because Owner should typically maintain most or all of the same records for its own purposes anyway. Owner’s failure to maintain these records could be disastrous should a “trust beneficiary” demand to examine them, especially if Owner could not reconstruct them quickly under pressure.

If Owner does not follow these two simple rules in disbursing trust assets, Owner may face dire consequences. Courts have wide latitude to fashion the “appropriate” relief to protect “trust beneficiaries.” Courts can recover “trust assets” disbursed to third parties, require Owner to replenish the trust, limit Owner’s authority over the trust, direct Owner to distribute trust assets based on a set priority scheme, and hold Owner (or certain Owner agents) liable for damages. The Lien Law even contemplates criminal liability.

II. Owner’s Strategies to Contend with Lien Law

Owner can and should plan a strategy early in the life of any Project—and certainly as soon as a prob-
A. Prepare the Battlefield

Contracts between Owner and GC must address the handling of Liens. In general, Owner should require GC to secure the discharge of Liens in a timely manner. If Liens are discharged, Owner must be exceedingly careful before disbursing funds to GC, because payments made to a GC after Owner receives notice of a Vendor’s Lien will not reduce that Lien, and Owner may end up paying twice for the same work.

B. Gather Information

Owner may not know its GC has been delinquent in paying Vendors until the moment Owner receives a Vendor’s Notice of Lien. With its bubble of blissful ignorance burst, Owner should promptly take all reasonable steps to collect information about its Project to (a) understand the whole picture, (b) plan Owner’s strategy, and (c) prepare to defend itself in court.

This information gathering should be given the highest priority. It may amount to a time-consuming ordeal. Even while Owner collects information, Owner will need to make some strategic decisions. Additional Notices of Lien will probably arrive during this process, further complicating matters.

1. Information Owner Needs

Owner will want answers to a variety of questions, including:

a. How much does Owner owe GC under the contract?

b. How much does GC owe to Vendors under their contracts?

c. What do these Vendors owe their Sub-Vendors?

d. To what extent have GC and Vendors substantially performed under their contracts?

e. Which Vendors have filed Liens?

f. Of the various GC and Vendor claims, how much covers labor?

g. How much retainage does Owner still hold, and what claims does Owner anticipate against the retainage?

2. Sources of Information

With any luck, Owner will already have maintained the records that Article 3-A requires. But those records, even when combined with information in Notices of Lien, will probably not give Owner a full picture of the Project. Owner should turn to other sources, including:

a. GC’s records;

b. Vendor records;

c. A full title search of the Site, to include an examination of any unrecorded but filed documents under the Lien Law;

d. A litigation search on GC and perhaps major Vendors; and

e. Physical inspection of the Site.

GC’s records probably constitute Owner’s best source of information, though Owner may have difficulty obtaining them, depending on the terms of Owner’s contract with GC, Owner’s leverage against GC at the time, and GC’s willingness to cooperate. Owners should consider retaining a forensic accounting firm to assist in unraveling the mess.

Even if the construction contract does give Owner the right to review GC’s payment records, GC might just tell Owner to take a flying leap—especially given that GC knows Owner will probably soon terminate GC’s contract anyway. Owner might have better luck by seeking the assistance of a cooperative Vendor. In doing so, Owner would indirectly take advantage of Article 3-A, which makes GC a statutory trustee of its own Article 3-A trust. As a result of that trust, Article 3-A allows Vendors to demand copies of GC’s records. Still, even if a cooperative Vendor exists, that Vendor may need a month to obtain GC’s records. Finally, if GC becomes subject to bankruptcy or similar protection, GC’s records may become publicly available.

C. Complete the Project: Dealing with the Lender

For Owner to achieve its primary goal, completing the Project, Owner will typically need a source for more funds. If a Lien has been filed against the Project, this will usually constitute a default under Owner’s construction loan and excuse the lender from further funding. The documents will, however, usually let Owner solve that problem by bonding the Lien.

Once Owner knows a Lien has been filed, Owner will usually want to notify its construction lender—so the lender hears about the problem first from Owner rather than from a regular title continuation—and be ready to answer the lender’s questions about the Lien. These questions will usually not vary much from the questions Owner will ask about the same Lien, as described above. More generally, the construction lender’s agenda will largely overlap Owner’s agenda, except that the lender will have some unique burdens, concerns, and risks driven by the “building loan” provisions of the Lien Law and a major recent surprise from the New York Court of Appeals in interpreting a lender’s risks under Article 3-A. That lender-specific rat’s nest lies beyond the scope of this article.

D. Bond the Project

The filing of a single Lien can function much like a drop of blood in a tank of sharks. Other Vendors will race to file their own Liens, further
completing Owner’s Project and relations with its construction lender.

Owner can, in theory, prevent other Vendors from filing additional Liens against the Site by filing a bond under Lien Law § 37. After Owner files such a bond, any future Liens will attach to the bond, not the Site. A § 37 bond is, however, quite expensive, typically costing 1% to 2% of the bond amount. It also requires Owner to deliver substantial credit support, perhaps at least the remaining cost of the Project plus some cushion, typically very unpalatable or even impossible. Finally, such a bond gives lien claimants tremendous leverage going forward, as it gives them security far superior to a claim against real property. Thus, Owner may not choose to file such a bond. One advantage of filing a Lien Law § 37 bond arises from the likelihood that Vendors may not pay enough attention and may still file Liens, instead of claims against the bond. If a Vendor does not re-file correctly within the time allowed for filing, it will no longer have a valid claim against the bond. Although such Vendors may have a malpractice claim against the attorney who was engaged to enforce the Vendors’ rights (and forgot to check whether a bond had been filed), they will no longer have a claim against Owner.

Should Owner decide to file such a bond, it should do so as soon as possible. In many cases, a bond under Lien Law § 37 does not discharge Liens that Vendors filed before Owner posted the bond, and Owner will have to file a separate bond for each Lien under Lien Law § 19.

E. Assume Contracts with Vital Vendors and Consider Replacing GC

If Owner can assure access to funds to complete the Project, Owner’s next challenge will be to try to stay as close to schedule as reasonably possible in finishing the Project. To do that, Owner may want to try to convince vital Vendors to stay on the job and finish their work. Otherwise, Owner risks further delays to the Project while Owner seeks new Vendors.

Owner’s general contract with GC will often allow Owner to assume the contracts of any Vendors it chooses, such as the vital Vendors. Before Owner does so, it should consider three issues:

1. Owner must confirm that its general contract does allow it to pick and choose which Vendor contracts to assume. Many, probably most, general contracts follow the AIA’s standard general contract, Form A201. That form gives Owner the ability to obtain the assignment of any Vendor contracts that it so chooses. Owner must first, however, terminate the general contract “for cause.” GC’s failure to properly pay Vendors constitutes sufficient cause under Form A201.

2. Owner must confirm that the appropriate court allows it the flexibility to choose which contracts it assumes—even if the general contract grants this flexibility—a question outside the scope of this article. Owner should also consider its longer term business relationships with the various Sub-Vendors when deciding which contracts to assume and which to terminate.

3. Third, Owner must be sure not to inadvertently assume any contracts it did not want to assume. Owner should assume the contracts of vital Vendors only if it can do so without assuming the contracts of non-vital Vendors. If Owner can’t, then it should try to negotiate new contracts with new vital Vendors. As a practical matter, Owner should try to negotiate these new contracts before it terminates its contract with GC. Otherwise, vital Vendors might stop work, in an attempt to obtain better contract terms from Owner. Owner’s agreement with GC should, ideally, require GC to give Owner copies of all contracts with Vendors promptly after being executed, and should state that GC automatically assigns those contracts to Owner following a default, termination of the General Contract, and Owner’s election to assume any affected contracts.

Owner should also take steps to try to limit potential recoveries by Vendors whose contracts Owner has assumed. Before assuming a contract, Owner should obtain an estoppel certificate from Vendor confirming the absence of defaults, other than payment, and establishing an agreed schedule for the payment of any balance for work already performed. In some cases, Owners have been known to condition their assumption of a contract upon Vendor’s agreeing to first pursue GC for the open balance before asserting any part of that open balance against Owner. In essence, this arrangement gives Vendor a choice between (A) asserting only limited remedies against Owner but being paid to complete the Project and (B) being terminated from the Project, but retaining its Lien rights. If construction lending is involved, any filed Liens will need to be discharged, which in turn may make the first alternative more palatable.

Finally, Owner may want to stop paying the remaining (non-vital) Vendors and GC. Although this will probably precipitate litigation, Owner has techniques available to minimize the resulting liability.

F. Minimize Exposure to Non-Vital Vendors

By selectively taking over contracts with vital Vendors, Owner may increase its chances of completing the Project and doing so on schedule. As its remaining goal, Owner will want to stay as close to budget as it
can. This will require finding ways to pay Lien holders less than what they claim in their Liens—but without violating Article 3-A.

1. Minimize Funds Owner Must Pay to Lien Holders

From Owner’s perspective, any payments Owner pays to resolve claims of non-vital Vendors are essentially wasted, because they give Owner very little benefit. These Lien holders will have probably already finished their work—given that otherwise they could not establish “substantial performance” (or “substantial completion” under the construction contract). Thus, any further work they might perform will not deliver to Owner any additional value. Owner should keep in mind, however, that a non-vital Vendor that has demonstrated “substantial performance” or “substantial completion” will have a Lien for the value of its work and/or a claim for breach of contract. Owner must get rid of any filed Liens unless it wishes to have an unmarketable Site, an unhappy lender, and a substantial risk of foreclosure. Thus, to the extent Owner can, it should reduce the amount that it must ultimately pay Lien holders to resolve the Liens. The Lien Law does give Owner several options to mitigate the amount Owner must pay.

As a particular compelling argument, Owner can argue that a Lien holder (or a party to whom the Lien holder has become subrogated) has not substantially performed under its contract. Given the factual scenario—an insolvent GC and a largely incomplete Project—it would seem highly likely that at least some party will have not substantially performed. If Owner can successfully assert that GC or a Vendor (or several) has not substantially performed, Owner can avoid paying the full Liens. 79 Though these Lien holders will be left with a remedy of quantum meruit, they face an uphill battle to collect. Given that Project completion will probably require Owner to pay more than what it agreed to pay GC to complete the Project, Owner may be able to argue that it did not benefit from the Lien holders’ work beyond what Owner has already paid.

Owner might also challenge the validity of any Liens. If Owner can successfully claim that a Lien holder does not meet one of the three substantive conditions of having a Lien (as summarized above), Owner may eliminate all payments under Article 2 to that Lien holder.

Owner might also assert that Liens were not properly filed because they violated one of the many technical requirements for filing a Lien.80

Before making any substantive or procedural challenge to a Lien, Owner will typically want to wait until after the deadline for filing (or re-filing) a Lien has passed—eight months from Project completion—before asserting its claim.81 After that point, if Owner successfully challenges a Lien, the Lien holder will probably not be able to re-file.82

Finally, Owner can challenge whether the amounts a Vendor claims in its Lien are reasonable. Any Notice of Lien must include the Lien holder’s statement of the agreed price or value of the labor performed and materials furnished when the Vendor files its Lien.83 The Lien holder’s claim must be reasonable based on the balance due. Owner can sometimes challenge the Lien amount on that basis. In addition, in the rare case where Owner can demonstrate that the Lien holder willfully exaggerated the amount of the Lien, the court can declare the Lien void and force the Lien holder to pay Owner damages, including bond premiums, and a penalty equal to the exaggerated piece of the Lien.84 The Lien holder will also have no right to file another Lien for that claim. Unfortunately for Owner, however, Lien claimants do not often willfully exaggerate their claims, and Owner may have trouble proving willfulness,85 which must be established in the trial of the foreclosure action.86 The question cannot be determined on motion prior to trial.87

2. Avoid Article 3-A Violations

Owner should take great care not to violate Article 3-A, such as by diverting “trust assets” away from the purpose of the trust or by failing to keep proper records. As long as Owner complies with Article 3-A, it can pay its vital Vendors in whatever order it chooses and can pay any remaining “trust beneficiaries” out of any “trust assets” that remain. And, given that Vendors will in most instances be “trust beneficiaries” when they also have claims for valid Liens, Owner will often not owe these “trust beneficiaries” any more than it would have paid to satisfy their Lien claims, anyway. Although this is often the case, Owner should note that Vendors can be considered “trust beneficiaries” whether or not they have filed or had the right to file a valid Lien.88

Owner should also bear in mind that if it assumes contracts of vital Vendors, as this article suggests an Owner might consider doing, Owner will become “obligated” to those Vendors under Article 3-A. Thus, those Vendors will become “trust beneficiaries” with trust claims equal to the full amounts of their contracts. Owners should always consider using an intermediary to act as a replacement GC going forward, or entering into separate new contracts if possible.

III. How Owners Can Plan Ahead to Prevent Lien Problems

The discussion above focuses on steps an Owner can take after a Project goes bad. If Owner could turn back the clock, though, or wanted to try to do better next time, what more could Owner do at the outset of a Project to prevent problems? This article concludes by offering a few suggestions. Some are just reminders of “best practices” in running construction jobs. Others have not been typical in construction projects either because they are expensive or a GC
will refuse to accept them. In today’s markets, though—at least until the next construction boom—GCs may decide to accommodate.

First, Owner can insist on monitoring the Project by requiring GC to keep good records and give Owner regular access to those records. Owner might condition any payments to GC on proof that GC has paid Vendors. If owner can persuade GC to agree to such measures, Owner must also bear in mind the possibility of fraud. Such owners should consider engaging a forensic accounting firm to keep an eye on the chicken coop.

Second, Owner can insist on having the right—even before GC gets into visible trouble—to pay Vendors directly, or through joint checks, instead of using GC as the middleman. Again, GC will typically object to such measures, Owner must also bear in mind the possibility of fraud. Such owners should consider engaging a forensic accounting firm to keep an eye on the chicken coop.

Third, Owner could obtain third-party assurances that GC will pay its Vendors. For example, GC could deliver to Owner a letter of credit, which Owner could draw upon if problems arose. Or Owner could require GC to deliver a payment bond, where a bonding company agrees that if GC does not pay its Vendors, then the surety will, up to the amount of the bond. Measures like these are often expensive. And if a GC’s credit is strong enough so GC can arrange measures like these, then traditionally any Owner would conclude that GC’s credit is also strong enough to make such measures unnecessary. Regardless of GC’s credit, however, Owner should remember that GCs sometimes do play games of the types that lead to trouble. And war stories abound regarding a GC who files a Chapter 11 petition with one entity on Monday and is back in business Tuesday with a new corporate entity using the plant, equipment, and other assets of the bankrupt entity.

Finally, Owner could try to hire a more creditworthy and reliable GC. Such a GC may charge more. But Owner may find that a GC with better credit means less likelihood of trouble. Of course, particularly after the events that have rocked the real estate and financial worlds since late 2007, Owner might conclude that no one is as reliable as he or she seems. Owners may seek credit enhancement in the form of performance bonds that guarantee completion of the project, although the litigation that is needed to realize on these bonds sometimes makes their protection illusory. Other credit enhancements that are gaining acceptance in the construction industry are standby credits, which are beyond the scope of this article.

In any event, Owners must recognize that New York law provides very meaningful rights and remedies for parties whose labor and materials go into a Project. The Lien Law is intended to help assure that those parties receive payment for their work. Owners must have a plan to ensure that these protected parties do not acquire the ability to derail the Project.

Endnotes

1. Owner may engage GC or, more commonly at least in New York City, a construction manager (“CM”). Under a traditional CM structure, Owner bears all financial risks of the Project, and CM enters into contracts with Vendors as Owner’s agent. That mitigates many risks this article describes, but replaces them with others. A variation on a CM structure imposes obligations that are similar to conventional contracting, and is known as “Construction Manager at Risk.” Even more complications arise if the Owner elects to use the “Design-Build” method of project delivery, where one entity performs both design and construction under a single contract. A CM arrangement will sometimes switch to a GC arrangement once the CM satisfies itself that very little risk remains in costing out the Project. This article considers only the implications of the CM structure for any Project. And this article limits itself to private/commercial Projects, as opposed to Projects undertaken for public agencies.

2. This article uses “Vendor” to refer to everyone—except GC—who may be owed money for a Project. Not every Vendor can always assert the Lien Law rights this article describes. The lines drawn will vary among various routes to recovery. Some Vendors, such as architects, will deal directly with Owner, not GC. The claims of such Vendors will be similar to GC’s. Other design professionals, such as engineers, and consultants, stand in a relation to the architect that is analogous to the contractor-subcontractor relationship. This article does not discuss those claims separately.

3. This would violate Lien Article 3-A, which prohibits a GC from using funds from one Project to pay debts of another unless GC has paid certain Vendors at the first Project. See N.Y. LIEN LAW §§ 70–79 (McKinney 2007), discussed at length below.


5. Such direct contractual rights would include, for example, any Vendor contracts that Owner has guaranteed or assumed. Vendors might have other avenues to claim a direct contractual relationship with Owner. For example, Vendor(s) and GC could enter into a so-called “liquidation agreement,” which is an arrangement where GC assumes liability for Owner’s actions so as to pursue Owner on behalf of Vendors. For more about these agreements, otherwise beyond this article, see Barry, Bette & Duke, Inc. v. New York, 240 A.D.2d 54, 56, 669 N.Y.S.2d 741, 743 (3d Dep’t 1998).

6. In an extreme case, diversion of trust assets also constitutes larceny. See N.Y. LIEN LAW § 79-a(1). Other parties, such as GCs and subcontractors, can also constitute “trustees.” Although this article does not exhaustively treat the trust fund obligations of these other trustees, any such trust follows the trust assets into the hands of transferees. This can sometimes produce surprises. For more on these surprises, see Connolly, supra note 4.

7. See Aspro Mech. Contracting, Inc. v. Fleet Bank, 1 N.Y.3d 324, 805 N.E.2d 1037 (2004), for an example of how the New York Court of Appeals sent a chill down the spines of construction lenders, as this article will briefly explain below.

8. See generally N.Y. LIEN LAW § 79 (nothing in Article 3-A prevents enforcement of a Lien under Article 2 or 3; and neither such Lien nor its satisfaction amounts to diversion of trust assets or unauthorized preference).
9. See, e.g., In re Marcus Substructure Corp., 76 A.D.2d 926, 429 N.Y.S.2d 722 (2d Dep’t 1980). The court considered a proposal to settle the claims of two classes of creditors—mechanics’ liensors under Article 2 and Article 3—a trust beneficiaries who did not hold mechanics’ Liens—by paying each creditor pro rata without regard to their class status. The court rejected this proposal, holding that “a class of mechanic’s lienholders must take priority over a class of mechanic’s nonlienor beneficiaries of a trust fund under [A] rticle 3-A of the Lien Law.” Id. (collecting cases in support).

10. For more about construction loans, see JOSHUA STEIN, STEIN ON NEW YORK COMMERCIAL MORTGAGE TRANSACTIONS, § 5 (2006); 8 WILLIAM X. WEED, WEED’S WEED NEW YORK REAL PROPERTY § 92.53 (5th ed. 2010) (hereinafter Warren’s Weed).

11. See Brainard v. County of Kings, 155 N.Y. 358, 50 N.E. 263 (1898) (finding that if nothing is due, according to the contract when the Lien is filed, but some amount later becomes due under the contract, the Lien attaches to the extent of that sum).

12. See N.Y. LIEN LAW §§ 9–11. Failure to comply with these technicalities can trigger significant problems for a Lien claimant. For example, LIEN LAW § 9 requires Lien claimants to include certain information in their notice of Lien. If they aren’t careful, these Lien claimants might, for example, forget to designate the block or blocks of real property to which the Lien will attach, which is required under LIEN LAW § 10. In addition, LIEN LAW § 11 requires Lien claimants to properly serve upon Owner their notices of Lien.

13. The statutory class includes contractors, subcontractors, laborers, materialmen (now often called material suppliers), landscape gardeners, and nurserymen. See N.Y. LIEN LAW § 3. Case law has expanded the list to include, e.g., draftsmen, engineers, surveyors, and architects. See 21 LAURENCE S. TAUBER, GENERAL PRACTICE IN NEW YORK § 10.5, n. 1, 2 (Robert L. Ostertag & James D. Benson eds. 1998) (hereinafter Ostertag & Benson).

14. See N.Y. LIEN LAW § 2 (“improvement” includes all work on real property and any work done on such property for its permanent improvement). N.Y. LIEN LAW § 2 defines “improvement” quite broadly. See Ostertag & Benson, supra note 13, § 10.6. The requirement of a “permanent” improvement distinguishes between works that remain after the Project is completed, and those that are transient. Even more confusion arises because the law treats the value of temporary works as lienable if and when those works are the means by which the permanent improvement is accomplished.

15. See N.Y. LIEN LAW § 3.

16. See id. § 4(1).

17. See, e.g., Klinik v. 66 East 80 Realty Corp., 15 Misc. 2d 911, 913-14, 185 N.Y.S.2d 1009, 1012-13 (Sup. Ct. N.Y. Cnty. 1959) (if contractor fails to fully perform under contract, contractor may still recover based on substantial performance). See id. for early cases discussing this issue.

18. See Frank v. Feiss, 266 A.D.2d 825, 826, 698 N.Y.S.2d 363, 364 (4th Dep’t 1999) (absent direct evidence of the reasonable value of the work performed or materials supplied, court can infer such value from the parties’ agreement); see also Pronti v. Smutzinger, 52 A.D.3d 1015, 1016, 861 N.Y.S.2d 148, 149 (3d Dep’t 2008) (price payable under void contract may evidence reasonable value for services).

19. See Cassino v. Yacevich, 261 A.D. 685, 687, 27 N.Y.S.2d 95, 98 (3d Dep’t 1941) (finding that a builder may recover the contract price where he has in good faith intended to comply with the contract, and has substantially complied with it); see also Pfeil Const. Corp. v. Moley, 14 Misc. 2d 379, 382, 179 N.Y.S.2d 443, 448 (Sup. Ct. Erie Cnty. 1958) (contract must be performed according to its terms, but trivial and innocent omissions trigger damages, not forfeiture).

20. See Spence v. Ham, 163 N.Y. 220, 226, 57 N.E. 412, 413 (1900) (“[t]he question of substantial performance depends somewhat on the good faith of the contractor. If [the contractor] has intended and tried to comply with the contract and has succeeded, except as to some slight things omitted by inadvertence, he will be allowed to recover the contract price, less the amount necessary to fully compensate the owner for the damages sustained by the omission.” (quoting Van Clief v. Van Vechten, 130 N.Y. 571, 579, 29 N.E. 1017, 1019 (1892)).


24. Id.


27. See Neshiv v. Baker, 104 A.D. 393, 394, 93 N.Y.S. 856, 856 (1st Dep’t 1905) (absent completion certificate, plaintiff needed to show a demand and unreasonable refusal by architect); see also Beecher v. Schuback, 4 Misc. 54, 55, 23 N.Y.S. 604, 606 (N.Y.C. C.P. Gen. T. N.Y. Cnty. 1893) (absent evidence that architect’s certificate was fraudulently or unreasonably withheld, recovery under contract was not possible).

28. See N.Y. LIEN LAW § 4(1) (limiting liability to value or agreed price of labor and materials remaining unpaid when notice of Lien filed).

29. Not every state limits Vendors’ claims in this way. Absent such a limitation, even if Owner paid GC, Owner still bears the risk that GC won’t pay Vendors. In these states, Owner must police GC. In New York, however, Owner has no obligation to see to GC’s proper application of funds.


31. Please see Section B below for a discussion of Vendor’s rights under Article 3-A.

32. See Electric City Concrete Co. v. Phillips, 100 A.D.2d 1, 4, 473 N.Y.S.2d 608, 610 (3d Dep’t 1984) (lienors derive rights from those of GC and cannot exceed Owner’s balance due GC).

33. See N.Y. LIEN LAW § 45 (court may adjust and determine equities of all parties).

34. Discussion of the fluid law of foreclosure in New York is beyond the scope of this article, but readers should be aware that the rule that contracts will be generally enforced as written, articulated in Graf v. Hope Bldg. Corp., has been eroded to such an extent that Justice Cardozo’s ringing dissent has come to be accepted as the better rule. Justice Cardozo wrote: “however fixed the general rule and the policy of preserving it, there may be extraordinary conditions in which the enforcement of such a clause according to the letter of the covenant will be disloyal to the basic principles for which equity
exists.” 254 N.Y. 1, 11, 171 N.E. 884, 887 (1930) (Cardoza, J., dissenting).


36. See N.Y. LIEN LAW § 13(1) (time of filing does not set priority of Liens).

37. See id. § 56.

38. The mere fact that a conveyance recites the required trust fund covenant may not give it priority over Liens filed later, if no fund was actually created. See Monroe Sav. Bank v. First Nat’l Bank of Waterloo, 50 A.D.2d 314, 317-18, 377 N.Y.S.2d 827, 830-31 (4th Dep’t 1976).

39. See N.Y. LIEN LAW § 13(1).

40. See id. § 56.

41. See id.

42. See generally Warren’s Weed, supra note 10, at § 92.50[3] (referencing N.Y. LIEN LAW §§ 13, 56; subcontractor has priority over subcontractor with whom he contracted and also over contractor with whom he contracted).

43. See N.Y. LIEN LAW § 13(1).

44. See id.

45. Id. § 56.

46. See generally M.F. Hickey Co. v. Imperial Realty Co., 65 Misc. 2d 1088, 1094, 319 N.Y.S.2d 972, 979 (N.Y. CIV. CT. NY. Cnty. 1970) (suggesting that if voluntary payments can defeat or diminish Lien rights of other Vendors, this seems inconsistent with N.Y. LIEN LAW § 56).

47. Many parties involved in a Project other than Owner can become trustees under Article 3-A.

48. For a full list of Owner’s trust assets, see N.Y. LIEN LAW §§ 70(5)(a)-(e), 71-a.


50. N.Y. LIEN LAW § 79-a provides: “Any trustee of a trust arising under this article, and any officer, director or agent of such trust, who applies or consents to the application of trust funds received by the trustee as money or an instrument for the payment of money for any purpose other than the purposes of that trust... is guilty of larceny and punishable as provided in the penal law...” See also People v. Chesler, 50 N.Y.2d 203, 205, 406, 428 N.Y.S.2d 639, 640 (1980) (discussing defenses to a charge of larceny in violation of Lien Law § 79-a).

51. See supra note 48 and accompanying text.

52. See N.Y. LIEN LAW § 70(2).

53. See id. § 70(4).

54. § 71(3)(a) (emphasis added).


56. See Weber v. Welch, 246 A.D.2d 782, 784, 668 N.Y.S.2d 71, 72 (3d Dep’t 1998). In Weber, Owner argued for dismissal of the “trust claim” of a Vendor who held a valid Lien. The court rejected Owner’s argument, holding that Vendor’s Lien made Owner potentially obligated to Vendor. For that argument to work, however, Vendor’s Lien must be valid. But see Innovative Drywall Inc. v. Crown Plastering Corp., 224 A.D.2d 664, 664, 638 N.Y.S.2d 722, 722-23 (2d Dep’t 1996) (Owner not “obligated” to a Vender because Vender’s Lien was defective and Vendor could not show Owner had any other contractual obligation to Vendor).

57. See Onondaga Commercial Dry Wall Corp. v. Sylvan Gen., Co., 26 A.D.2d 130, 133, 271 N.Y.S.2d 523, 525 (4th Dep’t 1966) (plaintiff could not show it was beneficiary of trust assets held by Owner, but could for trust assets received by contractor).

58. N.Y. LIEN LAW § 74(1).

59. Fortunately for Owner, if a trust beneficiary wants to show Owner diverted trust assets, the beneficiary must prove exactly that—actual diversion of trust assets. Merely failure to pay the trust beneficiary does not suffice. See Ryan Ready Mixed Concrete Corp. v. Caristo, 158 N.Y.S.2d 451 (Sup. Ct. Kings Cnty. 1959)

60. Article 3-A does, however, contain a priority scheme if Owner “diverted” trust assets. See N.Y. LIEN LAW §77(8).

61. Id. § 71(1).


63. A court will not automatically find that Owner diverted trust assets merely because Owner cannot provide the records. Such failure does, however, constitute “presumptive evidence” of diversion, placing on Owner the burden of proving a negative. See N.Y. LIEN LAW § 75(4).

64. See N.Y. LIEN LAW § 75(2) (Owner must keep records for its trust, and allocate amounts based on any commingled bank accounts); see id. § 75(3) (listing records—trust assets receivable, payable, received and payments made—Owner must provide to trust beneficiary upon demand). Owner doesn’t have very much time to comply with any such demand, so should have the records ready.

65. See generally N.Y. LIEN LAW § 76 (entitling any trust beneficiary, upon request, to examine the books or records, to make copies, or to opt for a verified statement setting forth information in such books or records).

66. See id. § 77(3)(a).

67. See id. § 79-a; see also People v. Miller, 23 A.D.3d 699, 803 N.Y.S.2d 734 (3d Dep’t 2005). In Miller, a GC that used “trust assets” to pay bills and expenses associated with unrelated construction projects was convicted of 32 counts of grand larceny and sentenced to concurrent prison sentences, the maximum of which was 5 to 15 years.

68. In a Notice of Lien, Vendor must allege (among other things) the work it has done, the unpaid balance for that work, and Vendor’s right to a Lien. When someone says colloquially that a Vendor filed a Lien, that usually means they filed a Notice of Lien. See generally N.Y. LIEN LAW § 9 (required contents of notice of Lien).

69. Id. § 37(1).

70. The lender will need to make sure that any loan to pay for “costs of improvement” qualifies as a “building loan” under the Lien Law. If the lender later modifies the terms of the loan, this may require unrelated construction projects was convicted of 32 counts of grand larceny and sentenced to concurrent prison sentences, the maximum of which was 5 to 15 years.

71. In Aspro Mech. Contracting, Inc. v. Fleet Bank, N.A., 1 N.Y.3d 324, 330, 805 N.E.2d 1037, 1040 (2004), the New York Court of Appeals held that a mortgage lender that takes a security interest in Owner’s construction contract steps into the shoes of Owner and is thus a “trustee” under Article 3-A. The construction lender can solve the problem by filing a Notice of Lending. Such a filing only protects advances made up to five days before the filing, on the date of filing or after the filing until the termination date specified in the Notice. See N.Y. LIEN LAW § 73; see also, 33 ROBERT RUBIN, SARAH BISER & CATHERINE KETTLE BROWN, NEW YORK CONSTRUCTION LAW MANUAL § 9.76 (2011 ed.).

72. See N.Y. LIEN LAW § 37 (upon approval of a bond, court shall discharge the property from Lien claims arising from contract described in such bond); see also Jensen, supra note 22, §268.

73. N.Y. LIEN LAW § 37(5).
74. Id. § 37(5) (claimant must perfect Lien claim within statutory deadline for filing notice of Lien).

75. Compare In re Rockefeller Center, Inc., 238 A.D. 736, 738, 265 N.Y.S. 546, 548 (3d Dep’t 1933) (§ 37 not intended to provide a method to discharge Liens filed before delivery of bond) with Trustees of Hanover Square Realty Investors v. Weintraub, 52 A.D.2d 600, 600-01, 382 N.Y.S.2d 110, 110 (2d Dep’t 1976) (suggesting § 37 bond also discharges previously filed Liens). See generally N.Y. Lien Law § 19 (discharge of a Lien for private improvement).

76. See AIA Document A201, supra note 23, § 14.2.1. Cause would also arise if GC provision of the Contract Documents.”

77. §14.2.1. Cause would also arise if GC “repeatedly refuses or fails to supply enough properly skilled workers or proper materials; fails to make payment to Subcontractors for materials or labor in accordance with the respective agreements between the Contractor and the Subcontractors; repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority; or otherwise is guilty of substantial breach of a provision of the Contract Documents.”

78. The Lien claimant bears the burden of proof on the amount and validity of its claim, thus must prove substantial performance. See Nesbit v. Braker, 104 A.D. 393, 394, 93 N.Y.S. 856, 857 (1st Dep’t 1905) (plaintiff bore burden of proof of substantial performance).

79. See supra note 12 and accompanying text for more details on these technicalities.

80. See supra note 12 and accompanying text for more details on these technicalities.

81. See N.Y. Lien Law § 10 (notice of Lien may be filed at any time during progress of work, or within eight months after completion of contract).

82. The deadlines in N.Y. Lien Law § 10 differ dramatically for a Project that constitutes a “public improvement.” See id. § 12 (deadline is 30 days after completion and acceptance of improvement).

83. See id. § 9(4).

84. See id. §§ 39 and 39-a.

85. Walker v. Security Trust Co., 85 Misc. 2d 614, 622, 379 N.Y.S.2d 308, 316 (Sup. Ct. Monroe Cnty. 1976) (“willful” means more than just doing the act or failing to do the act, but rather an intentional and deliberate doing of the act or failing to do the act with a certain awareness).


87. But see generally Joe Smith Inc. v. Otis-Charles Inc., 279 A.D. 1, 5 107 N.Y.S.2d 233, 236 (4th Dep’t 1951) (when appellant succeeded in having Lien discharged at commencement of trial, this terminated foreclosure action, leaving court without authority to declare Lien void for willful exaggeration).

88. N.Y. Lien Law § 71(4).

89. See id. § 71(3)(a) (“trust claims” can also mean any obligation of Owner incurred in connection with the improvement for a payment or expenditure defined as cost of improvement).

90. See, e.g., Kevin J. Connolly, Security for Contract Performance, 24 JOHN LINER REV. 2 (Summer 2010).

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