The Construction Money Mortgage in Arkansas

In Arkansas, the stated purpose of the loan can change the materialmen’s lien priorities. In the case of a mortgage with the stated purpose of funding for a construction project, a special priority is granted. We will discuss how a construction lender can take advantage of this priority and protect itself from an uncertain construction climate. There have been a number of changes in Arkansas law over the last few years that have materially changed the landscape faced by a construction lender. Some of these changes were by amendments to the materialmen’s lien laws and some through the courts. How these developments affect a construction lender can result in unexpected and adverse consequences. This article should help you in navigating around these problems. The distinction between residential and commercial construction largely affects the types of notices required to establish a lien and not the priority and substance of the lien laws. The issues discussed in this article will apply to residential and commercial projects, unless noted otherwise.

In this article, we will examine issues that are important to a construction lender doing business in the state of Arkansas. There are two broad areas of concern: (1) the priority assigned to a mortgage verses a materialmen’s lien; and (2) strategies for dealing with materialmen’s liens once the project has started. The lien priorities are affected by the date that construction project is deemed to have been “commenced” in relation the mortgage filing date. We will discuss the exception granted for a ‘construction money’ mortgage and special rules that apply. The law regarding pre-existing liens has changed and new procedures established regarding division of the foreclosure proceeds. Finally, we will discuss a number of strategies for dealing with a construction project by a lender during and after construction. This will include: the role and protections offered by a construction surety bond; the new rules that affect the ability of a lender to obtain information from the contractor; and, the means for removal of materialmen’s lien once filed.

1. Priority.

Arkansas, as most states, follows the first in time rule with regard to lien priorities. [1] The statutes concerning materialmen’s liens alter this rule and the relative value of an encumbrance. The most important aspect of this is the definition of the actual ‘commencement’ of a project. Prior to 1995, these rules were entirely determined by court cases. The lending and title community developed some standard expectations and procedures based on the court cases. However, in 1995 amendments to the lien statutes dramatically altered the definition of commencement in a way that left the standard procedures from the past in doubt.

Ark. Code Ann. §18-44-110 (1995), provides that construction or repair commences when there is a visible manifestation of activity on real estate that would lead a reasonable person to believe that construction or repair of an improvement to the real estatehas begun or will soon begin, including but not limited to the following: (A) delivery of a significant amount of lumber, bricks, pipe, tile, or other building material to the site; or (B) grading or excavating the site; or (C) laying out lines or grade stakes; or (D) demolition of an existing structure.

This statute is very different from the previous statute that required actual work to have commenced on the building. The list of examples given in the revised statute specifically overturned previous case precedent regarding ‘commencement’. [2]Under the previous statute, lenders and title companies could protect themselves with a simple photograph of the building site without improvements. Photographs are helpful, but the lender should make sure that if they use photographs then they should show the full property in sufficient detail. Proof of non-commencement is important because mortgages or encumbrances filed after commencement are inferior to the lien of the all of the materialmen on that project, even those who start after such mortgages are filed.

The materialmen’s lien statutes do provide an exception for a mortgage when the funds are intended for funding construction or repair of the improvement. Arkansas is not a ‘trust fund’ state and a bank, once it places the proper ‘construction loan language’ in its mortgage, [3]is not required to take much action to make sure that the loan proceeds actually go to pay for the project. [4] The mortgage must meet the following requirements: (1) the mortgage must be executed and recorded before commencement of the building; (2) the mortgagee must be unequivocally bound to advance money for construction; and (3) the recorded mortgage must show that the mortgagee is unequivocally bound. The courts in Arkansas look to the purpose rather than the actual use. However, from a purely practical standpoint the construction lender should be concerned that the funds are not diverted, as the value of an incomplete project may not be sufficient to support the loan amount.

In addition, recent case law has changed the interpretation of an Arkansas statute that establishes priority between a materialmen’s lien and any prior mortgages. For many years, the words in the statute would have made it appear that a materialmen’s lien would be superior to a pre-existing mortgage. However, case law from early times had largely rendered this statute void. This was changed by the case *Simmons First Bank v. Bob Callahan Serv.*, 13 S.W.3d 570 (2000), the Arkansas Supreme Court changed the remedy and in effect revived the materialmen’s lien priority in the improvement. The case turned on the ancient law of fixtures and a detailed analysis of the statute, which you will be spared. From a practical standpoint, the prior mortgage holder retains a first interest in the value of the real property and the materialmen’s lien is given a preference in the value of the improvement. This is done by use of a double appraisal; the property is appraised without any improvement and then again with the improvement. This establishes the relative value of each and the foreclosure proceeds are distributed on a pro rata basis. Neither party is left out in the cold.

2. Strategies for protection.

There are a number of strategies that a construction lender may use to protect itself from real world issues that materialize during the construction process. While a construction money mortgage does not require the lender to be hyper vigilant over the use of the loan proceeds to maintain priority, the simple fact that an incomplete project is worthless ought to require some protective measures. No amount of inspections can protect the lender from the financial condition of the contractor. The insolvency of a contractor can strike even those that are large, well managed and established.

The best protection against liens and insolvency is the requirement on commercial projects that the contractor produce a payment and performance bond. These bonds protect from not only unpaid subcontractors and suppliers, but also provide a source of funds and a means to finish the project. When the contractor fails to pay its subcontractors, labor, and suppliers it loses the ability to do any further work. The threat to the lender’s collateral then is not the priority of lien claims, but the fact that a lot with an unfinished house or office building on it may have no value at all. The lender of course always has recourse to its customer, but the average property owner, residential or commercial, generally lacks the knowledge and ability to resurrect the project. The recent trend is that project designers have largely withdrawn from the supervision of the projects, leaving the owner and lender to handle problems. A payment and performance bond will provide a source of funds and perhaps some practical aid in completion.

The construction lender does have some new tools to deal with liens once they have been filed. Under Ark. Code Ann. § 18-44-108 (2010), “[r]efusal to list parties doing work or furnishing materials,” provides a mortgage holder the right to issue a demand to the contractor to furnish within five days a list of subcontractors and suppliers for the project and the amount owed. This has been the law for some time but until 2009, there was not a practical enforcement mechanism. There is now a right for civil action to force this information from the contractor. How the courts will treat this right and whether lenders will make use of it remains to be seen. The right exists whether or not there is any ‘probable cause’ and can be used at any time. A careful lender has the tools now to make sure that funds paid to the contractor have been properly applied.

Arkansas has had a process to allow liens to be ‘bonded off’ of a project for many years. Recent changes should make this procedure easier to use. Ark. Code Ann. § 18-44-118 (2010), allows a property owner or contractor to file a surety bond to which liens are attached and are thus removed from the property. The bond previously required that the bond amount be double the amount of the lien claim; now, it requires only as much as the lien claim. This should have the practical effect of making it easier to bond around a lien. This same statute provides a summary proceeding to allow frivolous liens, filed without the proper notices, to be removed in an expedited manner. This was brand new in 2009 and no one knows how the courts will interpret this new right. However, it does provide a means for certain liens to be cleared without some of the delays associated with litigation.

The principal distinction between residential and commercial construction relates to the types and timing of the various notices required. Since a construction lender will never file such a materialmens’ lien and the length of the article is limited, these notices have not been discussed. The most important take away points for this article are the effect and definition of the commencement of a project, the lender’s ability to secure pertinent financial information while the project is ongoing, and consideration for the use of payment and performance bonds. While surety bonds are largely unavailable in the residential context, they should be a consideration on all commercial projects. The Arkansas Materialmen’s Lien statutes provide the lender with many protections, but the lender must be careful and vigilant.

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**END NOTES**

1. *Dempsey v. McGowan*, 722 S.W.2d 848 (1987) “Some of the funds released by the mortgagee were used by the mortgagor for purposes other than construction; however, when determining priority of liens we consider the purpose for which the funds were supplied rather than the use which was made of the money.” *Sebastian Bldg. & Loan Ass’n v. Minten*, 27 S.W.2d 1011 (1930). *See* *Spickes Bros. Paint Cont.v. Worthen Bank & Trust Co.,* 771 S.W.2d 258 (1989) “Although we have encountered cases where a portion of the proceeds from the construction money loan was applied other than for the payment for improvements either with or without the knowledge of the mortgagee, we have never ruled that the materialmen had liens superior to the amount of the construction money mortgage lien as finally determined when the above conditions have been met.”

2. These cases have been specifically overturned under the current statute. *See* *Mark's Sheet Metal v. Republic Mtg. Co.,* 414 S.W.2d 106 (1967); this court explained that the commencement of buildings and improvements "means some visible or manifest action on the premises to be improved, making it apparent that the building is going up or other improvement is to be made . . . This must be done with the intention and purpose then formed to continue the building to completion." and *See* *Jim Walter Homes v. Bowling Bldg. Supply*, 521 S.W.2d 828 (1975), Removing the foundations of old buildings on the premises, commencement of leveling operations and the establishment of cut and fill elevations are not sufficient evidence of commencement. *Clark v. General Elec. Co.*, supra. An inspection and measurement of the premises and the placing of a wooden peg to determine the location of a proposed house on the premises are not sufficient.

3. *Dempsey v. McGowan*, 722 S.W.2d 848 (1987) In order to establish a construction money mortgagee's priority over materialmen's liens, the following conditions must be satisfied: (1) the mortgage must be executed and recorded before commencement of the building; (2) the mortgagee must be unequivocally bound to advance money for construction; and (3) the recorded mortgage must show that the mortgagee is unequivocally bound. *Planters Lumber Co. v. Jack Collier East Co.*, 356 S.W.2d 631 (1962).

4. *Dempsey v. McGowan*, 722 S.W.2d 848 (1987) “Some of the funds released by the mortgagee were used by the mortgagor for purposes other than construction; however, when determining priority of liens we consider the purpose for which the funds were supplied rather than the use which was made of the money.” *Sebastian Bldg. & Loan Ass’n v. Minten*, 27 S.W.2d 1011 (1930). *See* *Spickes Bros. Paint Cont.v. Worthen Bank & Trust Co.,* 771 S.W.2d 258 (1989) “Although we have encountered cases where a portion of the proceeds from the construction money loan was applied other than for the payment for improvements either with or without the knowledge of the mortgagee, we have never ruled that the materialmen had liens superior to the amount of the construction money mortgage lien as finally determined when the above conditions have been met.”