Mortgage vs. Mechanic's Lien Priority Issues in Indiana

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Indiana has a significant body of legislation and case law addressing the priority of mortgages vs. mechanic's liens. The banking and construction industries in Indiana are well developed and funded and have over the years sought to establish clearer rules for determining the priority of their liens. Ultimately this led to the adoption in 1999 of what is commonly referred to as the "Lender Exception" as defined in Indiana Code section 32-28-3-5(d), which provides that, as to commercial property (including commercial residential property, *e.g.,* apartment complexes), "[t]he mortgage of a lender has priority over all liens created under this chapter [the mechanic's lien chapter] that are recorded after the date the mortgage was recorded, to the extent of the funds actually owed to the lender for the specific project to which the lien rights relate."

A recent case further clarified and refined the law in this area to confirm that the use of a lease as the debt instrument (rather than a promissory note) and a lease hold mortgage (rather than a mortgage on the fee interest) do not prevent a bank from obtaining priority under the Lender Exception. *Kellam Excavating Inc. v. Community State Bank*, 82 N.E.3d 928 (Ind. Ct. App 2017).

The Indiana Court of appeals summarized the facts in *Kellam* as follows: "Community State Bank (the Bank) provided financing to Sagamore Warehouse, LLC (Sagamore), for the construction of a fertilizer plant by Kellam Excavating, Inc. (Kellam), on property Sagamore leased from Winamac Southern Railway Company (Winamac). Kellam did not receive full payment for its work and filed a mechanic's lien. After Sagamore and Kellam filed complaints against each other, the Bank intervened and filed a third-party complaint to foreclose on its leasehold mortgage [Leasehold Mortgage] on Sagamore's property. The Bank also filed a motion for summary judgment, arguing that its interest in the property should receive priority. The trial court entered summary judgment for the Bank, finding that its mortgage takes priority over Kellam's mechanic's lien. Kellam appealed, arguing that the trial court erred in prioritizing the Bank's interest. Finding no error, the Indiana Court of Appeals affirmed." The Indiana Supreme Court declined to take the case so the Court of Appeals decision stands.

Kellam argued that the Leasehold Mortgage was not a mortgage because it was described as a leasehold mortgage, Sagamore did not promise to repay the Bank for the funds the Bank expended, and Sagamore did not execute a promissory note. The court rejected these arguments and found that regardless of what the

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Bank's financing document was called, it operated like a typical mortgage. The instrument granted the Bank a lien against Sagamore's property rights and the lien secured Sagamore's obligation to repay the Bank for the funds the Bank expended. As to Kellam's contention that the Leasehold Mortgage is not a mortgage because Sagamore did not execute a promissory note, Kellam failed to cite any authority that states that a promissory note was required to execute a valid mortgage, nor did the court of appeals find any. Accordingly, it found that the Bank's Leasehold Mortgage was a mortgage for the purposes of the Lender Exception.

The court ultimately found that the parties did not dispute that the real estate and facility improvements were commercial property or that the Bank recorded its Leasehold Mortgage before Kellam recorded its mechanic's lien. The funds that the Bank loaned were secured by the mortgage for the specific project—the facility improvements— that gave rise to Kellam's mechanic's lien. In short, the Bank's mortgage secured its loan of funds used to construct the facility improvements. The Lender Exception applied, and as a result, the Bank's mortgage was superior to Kellam's mechanic's lien.

In summary, the Indiana's Lender Exception granting priority of a mortgage over a mechanic's lien as provided under Indiana Code section 32-28-3-5(d) applies even if the lender uses a lease as the debt instrument (rather than a promissory note) and a lease hold mortgage (rather than a mortgage on the fee interest).