December 2013 Vol. 58, No. 3

ILLINOIS STATE BAR ASSOCIATION

Commercial Banking, Collections & Bankruptcy Law

The newsletter of the Illinois State Bar Association's Section on Commercial Banking, Collections & Bankruptcy Law

The aftermath of *Cypress Creek*—How newly-enacted HB 3636 affects commercial mortgage lenders

By Thomas M. Lombardo

On February 11, 2013, House Bill 3636 was signed into law by Governor Quinn, immediately modifying the Mechanics Lien Act in response to the Illinois Supreme Court's decision in LaSalle Bank National Association v. Cypress Creek I, LP, 242 Ill. 2d 231 (2011). This article provides a real-world example of exactly how these changes to the Act affect a commercial real estate foreclosure with post-mortgage mechanics liens.

Under *Cypress Creek*, which HB 3636 essentially reversed, the Foreclosing Lender stood in the shoes of any and all contractors who were paid, either from loan proceeds or from the Borrower's personal funds. Assume there was a $9,000,000 mortgage loan, and the Property was worth $8,000,000 when the loan was made. Also assume that $1,000,000 from the loan paid for improvements, but that the Borrower obtained another $1,000,000 in improvements which were not paid for, resulting in two mechanics liens for $500,000 each. Finally, assume the Property only sold for $5,000,000 at the foreclosure sale.

If the Court agreed that the Property was worth $8,000,000 before the improvements were made, and that $2,000,000 in improvements took place, then the Court created "two funds" totaling $10,000,000. The Lender was entitled to 100% of the $8,000,000 fund attributable to the value of the Land before the improvements. Under *Cypress Creek*, the Lender was also entitled to 50% of the $2,000,000 fund attributable to the improvements, since the loan proceeds and the owner paid for 50% of the improvements. The other two lien claimants each were entitled to 25% of the fund attributable to the improvements.

The $8,000,000 fund was 80% of the total improved value of the land, and the $2,000,000 fund was 20% of the total improved value of the land. The Court would apply this 80/20 ratio to the sale price, and divide the proceeds accordingly. Under *Cypress Creek*, the land value fund would be 80% of the sale proceeds, or $4,000,000, which the Lender was entitled to. The improvements fund would be 20% of the sale proceeds, or $1,000,000, of which the Lender was entitled to 50%, or $500,000. The lien claimants would each receive 25% of the improvements fund, or $250,000 each.

In enacting HB 3636, the Legislature and Governor Quinn decided to prioritize contractors over lenders, even where lenders or owners paid for some of the improvements.

HB 3636 reversed the foregoing apportionment formula. If we assumed the exact same fact pattern, but applied HB 3636 instead of *Cypress Creek*, the Lender is not entitled to any of the fund attributed to the improvements. Worse, the two lien claimants actually benefit from the improvements paid for by the Lender or the owner.

In our hypothetical, the Lender still recovers the land value pegged at 80% of the sale proceeds under HB 3636. However, the Lender is not allowed to participate in the improvements fund. Instead, the entire $1,000,000 improvements fund is divided up by all the mechanics lien claimants. If there are only two lien claimants, each having improved the land by $500,000, and if the total improvements are $2,000,000, the lien claimants will each be entitled to 50% of the improvements fund. Since the $5,000,000 sale price left $1,000,000 in the improvements fund, each lien claimant now recovers their full $500,000. (Note that, in the unlikely case where this new formula resulted in the lien claimants recovering more than they actually were entitled to under their liens, which is possible where an owner or lender funds improvements and only minimal mechanics liens are recorded in comparison, the remainder of the improvements fund should shift back to the Lender.)

In our fact pattern, the new law only allows the Lender to recover a total of $4,000,000. But under *Cypress Creek*, the Lender would have recovered $4,500,000.

In enacting HB 3636, the Legislature and Governor Quinn decided to prioritize contractors over lenders, even where lenders or owners paid for some of the improvements. Despite this change in the law, the Lender might have one way to reduce its potential losses. If a Lender settles a mechanics lien claim during a foreclosure action, it should insist on an assignment of that lien, not a release. This way, the Lender could attempt to

stand in the shoes of the settling lien claimant as an assignee.

Unfortunately, the only way to prevent the new law from adversely impacting a Lender altogether would be to have a borrower or escrow agent refuse to pay any contractor unless they first filed a mechanics lien, requested payment, and assigned the lien to the Lender upon payment. This is not, of course, a reasonably workable solution in real-world situations, and could be deemed an improper end-run around HB 3636. ■

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