GINSBERG JACOBS LLC

Loan Workout Advisor

Issue No. 2 July 1, 2011

Understanding the Mechanics of Mechanics Liens – Avoid Negotiating Against Yourself

by Thomas M. Lombardo

Mechanics liens may be one of the toughest issues for a loan workout specialist to tackle. Not only has your borrower missed a few principal and interest payments, he has also failed to pay his taxes and they are about to be sold to the vultures. And now, to make matters worse, you start getting something called a "Section 24 Notice" from numerous contractors that you have never heard of, all claiming that they "improved" your real estate collateral but didn't get paid. Then, after you order a title report and start gearing up for a foreclosure, deed-in-lieu or note sale, you learn that there are a dozen or more mechanics liens on the property, which add up to a startling amount, all claiming to be ahead of your mortgage.

It was bad enough that your appraisal came in at 50% of the loan balance and your guarantors filed for bankruptcy. But now, with all those mechanics liens, you begin to wonder if your loan is secured at all, and you start calculating just how much of a loss you are going to have to book on this deal. Worse still, you begin to face the grim reality that you may actually have to cut checks to some of those lien claimants in order to get a workout or even a foreclosure done.

Before picking up that phone to call the original loan officer and ask why they didn't get a personal guaranty from Bill Gates, it would be worthwhile to find out exactly how much of your loan proceeds went to pay for construction work and other improvements on the property, as opposed to simply land acquisition or soft costs. If the loan did fund improvements, then you may be in much better shape than you think. Indeed, you may actually be a mechanics lien claimant, of sorts.

First, it is important to understand the concept of "enhancement." Simply put, a mortgage recorded first in time has priority over valid, subsequently-recorded mechanics liens (which regardless of recording date, always relate back to the date of contract with the owner). However, if the contractor's work "enhanced" the value of the land, meaning that it led to improvements on the property, then the perfected mechanics lien claimant takes priority over earlier mortgages, to the extent of the value of those enhancements. At the same time, the mortgagee maintains its priority over the unimproved value of the land at the time of the mechanics lien claimant's contract. Of course, disputes often exist as to the value of the improvements, but the most common way to measure that value known as the "contract method," which looks no further than the amount of the lien claimant's contract.

Still, when the property in question is not worth enough to pay a mortgagee and all valid mechanics liens, the analysis does not stop at the value of the enhancements or the unimproved property's value. Indeed, very recently, the Illinois Supreme Court handed down the lender-friendly decision of LaSalle Bank National Association v. Cypress Creek 1, LP (Docket No. 109954, February 25, 2011), which gives construction lenders a new weapon in their arsenal against mechanics liens.

In a nutshell, the Court in Cypress Creek 1 placed mortgagees on even ground with mechanics lien claimants to the extent that the bank's loan was used to pay off contractors which could have otherwise been mechanics lien claimants. Previously, a bank likely would not have enjoyed this status unless it had paid off contractors after they had actually recorded liens, under a concept called subrogation. Of course, as the Illinois Supreme Court noted, banks typically utilize a construction escrow process to ensure that paid-off contractors do not record liens, and therefore subrogation was practically impossible in most instances.

So how does Cypress Creek 1 affect a bank's position when the proceeds from the foreclosure sale are not enough to pay off all lien claimants? Here, the answer is one of simple math. Assume that lender "Bank" gave "Borrower" a $2,000,000.00 "Loan" that was secured by a mortgage on the "Property." Also assume that $1,000,000.00 of the Loan was used for land acquisition, and another $1,000,000.00 was used to pay for the work of two contractors, "Builder A" and "Builder B," through construction draws. However, Borrower also hired a third contractor, "Builder C," who had a $500,000.00 contract but was never paid, resulting in a valid mechanics lien against the Property. Based on the land acquisition value plus the improvements, the Property has a hypothetical value of $2,500,000.00. Because of "enhancement," Builder C's mechanics lien has certain priority over the earlier mortgage.

In this scenario, the Bank has a lien on the unimproved land value of the Property that is equal to 40% of the total improved Property value ($1,000,000.00/$2,500,000.00=40%). The improvements represent the other 60% of the total improved Property value ($1,500,000.00/$2,500,000.00=60%). The Court in Cypress Creek 1 reasoned that this value of the improvements should be apportioned amongst the lien claimants and the Bank to the extent that its loan proceeds paid for improvements to the land. Therefore, using a pro rata formula, the Bank paid for 66.6% of the improvements ($1,000,000.00/$1,500,000.00=66.6%), and Builder C contributed to 33.3% of the improvements ($500,000.00/$1,500,000.00=33.3%).

Of course, if the Property sold for its "full value" at the foreclosure auction, there would be enough money to pay the Bank as mortgagee, plus the Bank and Builder C for their share of the improvements. However, in nearly every case, the actual value of the Property is far less than the sum of all its liens. Hypothetically, let's say that this property sold for $1,500,000.00, leaving a deficiency of $1,000,000.00 between the Bank and Builder C. In this example, the Bank would get $600,000.00 for its lien on the unimproved land ($1,500,000.00x40%=$600,000.00). However, under Cypress Creek 1, the Bank would also get an additional $599,400.00 for its hypothetical "mechanics lien" on the improvements that it funded when the loan was in service ($1,500,000.00x60%=$900,000.00x66.6%=$599,400.00). Likewise, Builder C would get $299,700.00 on its lien ($1,500,000.00x60%=$900,000.00x33.3%=$299,700.00).

GINSBERG JACOBS LLC

Clearly, the Cypress Creek 1 decision has very tangible benefits to construction lenders facing mechanics liens. Until the decision in Cypress Creek 1, it is very likely that those lenders would not share in the value of the "improvements," while the existing lien claimants would end up recovering far more than their fair share, at the lender's expense. But now that Cypress Creek 1 is the law of the land, loan workout specialists should take the time to understand the "mechanics" of mechanics liens on their collateral, and be sure to reserve against, and value, their troubled loans accordingly. Moreover, since most mechanics liens are settled well short of foreclosure, lenders should also make sure that they start their negotiations with lien claimants at an appropriately low figure which takes into account the lender's slice of the improvements. Indeed, following Cypress Creek 1, the true value of a mechanics lien likely to be far below the amount on the face of the recorded lien.

Every case involving mechanics liens is different, and not every scenario will fall neatly into the framework set forth in this article. Issues concerning perfection, or the actual validity of the lien itself, should always be evaluated by an attorney that is well-versed in the nuances of mechanics lien law. In all cases, an analysis of each and every mechanics lien should be performed by counsel, to ensure that the lien claimant complied with the numerous requirements of the Mechanics Lien Act, and that its lien has the potential for priority over the lender's mortgage. We welcome you to contact one of our attorneys to discuss these issues and to answer any questions that you may have.

This is our second issue of the Loan Workout Advisor, which is published every few weeks and includes advice to our real estate and asset-based lending clients regarding aspects of loan workouts, modifications and foreclosures.

Our Loan Workout team consists of:

Steven "Sonny" F. Ginsberg
312.660.9614
sginsberg@ginsbergjacobs.com

Ana L. Acena
312.660.9618
aacena@ginsbergjacobs.com

Jeffrey E. Altshul
312.660.9629
jaltshul@ginsbergjacobs.com

Thomas M. Lombardo
312.660.2202
tlombardo@ginsbergjacobs.com

Karen Halm-Lutterodt
312.660.9621
khalm.lutterodt@ginsbergjacobs.com

Ari Rosenthal
312.660.9625
arosenthal@ginsbergjacobs.com

Joel V. Sestito
312.660.2201
jsestito@ginsbergjacobs.com

Janet H. Winningham
312.660.9627
jwinningham@ginsbergjacobs.com

GINSBERG JACOBS LLC

300 South Wacker Drive, Suite 2450
Chicago Illinois 60606
Tel 312.660.9622 Fax 312.660.9612
ginsbergjacobs.com