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The Aftermath of Cypress Creek: How HB 3636 Affects Lenders

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House Bill 3636 was sent to the Governor for signature on January 11, 2013. The Governor has sixty days to veto the Bill or it becomes law. This article provides a real-world example of exactly how House Bill 3636 will affect a commercial real estate foreclosure with post-mortgage mechanics liens.

Under Cypress Creek, which HB 3636 essentially reverses, the Foreclosing Lender would stand 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 $9,000,000.00 mortgage loan, and the Property was worth $8,000,000.00 when the loan was made. Also assume that $1,000,000.00 from the loan paid for improvements, but that the Borrower obtained another $1,000,000.00 in improvements which were not paid for, resulting in two mechanics liens for $500,000.00 each. Finally, assume the Property only sells for $5,000,000.00 at the foreclosure sale.

If the Court agrees that the Property was worth $8,000,000.00 before the improvements were made, and that $2,000,000.00 in improvements took place, then the Court creates "two funds" totaling $10,000,000.00. The Lender is entitled to 100% of the $8,000,000.00 fund attributable to the value of the Land before the improvements. Under Cypress Creek, the Lender was also entitled to 50% of the $2,000,000.00 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 $8,000,000.00 fund was 80% of the total improved value of the land, and the $2,000,000.00 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 $4,000,000.00, which the Lender was entitled to. The improvements fund would be 20% of the sale proceeds, or $1,000,000.00, of which the Lender was entitled to 50%, or $500,000.00. The lien claimants would each receive 25% of the improvements fund, or $250,000.00 each.

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

The Lender under HB 3636 would still recover the land value pegged at 80% of the sale proceeds. However, the Lender would not be allowed to participate in the improvements fund. Instead, the entire $1,000,000.00 improvements fund would be divided up by all the mechanics lien claimants. If there were only two lien claimants, each having improved the land by $500,000.00, and if the total improvements were $2,000,000.00, the lien claimants would each be entitled to 50% of the improvements fund. Since the $5,000,000.00 sale price left $1,000,000.00 in the improvements fund, each

lien claimant would recover their full $500,000.00. (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, HB 3636 only allows the Lender to recover a total of $4,000,000.00. But under Cypress Creek, the Lender would have recovered $4,500,000.00.

In enacting HB 3636, the Legislature 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 does have one way to reduce its potential losses. If a Lender settles a mechanics lien claim during the foreclosure action, it should insist on an assignment of the lien, not a release. This way, the Lender could stand in the shoes of the settling lien claimant as an assignee.

Unfortunately, the only way to prevent HB 3636 from adversely impacting the 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, however, a reasonably workable solution in real-world situations, and might eventually be deemed an improper end-run around HB 3636.

If you have any questions about HB 3636, foreclosure actions or mechanics liens, we invite you to contact one of our attorneys.

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

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