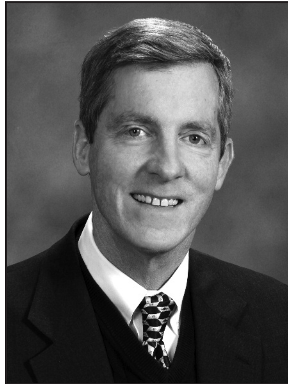
SINCE 1854

Chicago Daily Law Bulletin

Serving the Last Slice:

The Supreme Court's Recent Decision in *LaSalle Bank v. Cypress Creek 1, LP*

By David W. McArdle and Gregory J. Barry


David W. McArdle

Allocating sale proceeds in a mechanics lien case can be analogized to slicing up a pie that's too small to feed all the diners. Under section 16 of the Mechanics Lien Act, lenders get the slice attributable to the land's value, and mechanics lien claimants get the slice attributable to their share of the improvements. However, in some cases, there are contractors who have been paid. If these contractors are "full," who gets their slice—the lender or the unpaid contractors?

This question has been a part of Illinois jurisprudence since the mid-19th century, although strangely enough not to such an extent as to produce a definitive court opinion settling the law. The Supreme Court's recent decision in *LaSalle Bank N.A. v. Cypress Creek 1, LP*, 2011 WL 681797 (Feb. 25, 2011, not yet released for publication in Ill.2d), however, resolves the primary question of who gets the missing dollar, settles other related priority issues, but leaves further questions unresolved. The Court, interpreting Section 16 and prior case law, held that the construction mortgagee would have priority to the value attributable to non-claimant contractors if the mortgagee financed those improvements. By placing construction lenders—even those who continued to authorize draws even after the owner defaulted—in the owner's shoes, the Court handed construction lenders a major victory, especially to those who are able to purchase the property at the foreclosure sale.

The subject development was a senior living apartment complex in Bolingbrook. The owner took out a construction loan with LaSalle, which secured the loan with a recorded mortgage. The owner hired contractors for the project, including claimants Eagle Concrete and Edon Construction. Eventually, LaSalle realized that the project could not be completed with the available funds and filed to foreclose the mortgage. However, LaSalle had paid other contractors with funds from the loan, even after the owner had defaulted. After the claimants recorded their liens, LaSalle obtained a judgment and purchased the property at the sheriff's sale. The lien claims were consolidated with the mortgage foreclosure action to determine the priority of liens and distribution of the sale proceeds.

Because the improvements were not yet completed and actual market value of each improvement was difficult to ascertain, the trial court used the "contract method" and valued each improvement at its contract price. It determined 60% of the value was attributable to the improvements and 40% to the land itself prior to improvements. The 40% "land" share of the proceeds (minus costs and fees) went to LaSalle as mortgagee. The 60% share was divided based on the proportional share that each lien claimant contributed to the improvements. Eagle's and Edon's liens accounted for 3% and 15% of the value of the improvements, respectively. LaSalle was subrogated to the 76% of the improvements that it financed, and the other lien holders took the remaining 6%.

On appeal, the Third District held affirmed the rulings on priority, but reversed on subrogation, finding that LaSalle should only be subrogated to the extent that it had paid on perfected mechanics liens. The funds to which LaSalle was no longer subrogated were to be divided proportionally among the mechanics lien claimants. The appellate court recognized that "enhanced value produced by payments by the owner while the work was progressing should be applied to the satisfaction of the mortgage."

Nevertheless, the appellate court treated the issue of the missing payments as one of subrogation, and a factual issue, rather than one of an interpretation of the Mechanics Lien Act. The court looked to the Fourth District's opinion in *Detroit Steel Products Co. v. Hudes*, 17 Ill.App.2d 514 (4th Dist. 1958) for the principle that construction lenders become subrogated when they pay lien claimants, but must prove their right to subrogation through the "sworn statement of lien claimants."

After determining that LaSalle had no priority over the value provided by non-liening contractors, the appellate court had to determine how to allocate the proceeds attributable to the value added by those contractors. In order to deal with this difficulty, the court concocted a rebuttable presumption that such proceeds should be divided among perfected mechanics lien claimants: "Under the instant circumstances, the record is devoid of any proof that Edon and Eagle, as claimants with perfected liens, would be required to share the sale proceeds with anyone except the other claimants with perfected liens." LaSalle was only entitled to priority over the proportionate value of the land as well as the one perfected lien where LaSalle was deemed to be subrogated by having paid for the work.

Rather than reviewing the Appellate Court's foray into subrogation and equitable factors, the Supreme Court began its analysis with Section 16 of the Mechanics Lien Act, and more specifically at its central clause on priority: "upon questions arising between incumbrancers and lien creditors, all previous incumbrances shall be preferred to the extent of the value of the land at the time of making of the contract, and the lien creditor shall be preferred to the value of the improvements erected on said premises." The Court pointed out, though, that: "[h]istorically, this provision has been interpreted by the appellate court to give each mechanics lien claimant priority only to the extent of the increased value of the property due to that claimant's improvements on the property." With that observation on Section 16, the court all but discarded the appellate court's rebuttable presumption that all value attributable to contractors is divided among mechanics lien claimants.

Eagle contended that because Section 16 referred to "the contract" and "lien creditor" in the singular but to "the improvements" in the plural, that the Mechanics Lien Act "gives as few as one lien creditor preference to the value of all improvements erected on the premises after the date that the mortgage attached." The Supreme Court rejected this interpretation and found that the only logical and unambiguous resolution of Section 16 "prioritizes lien creditors only to the value of their improvements and the prior incumbrancer to the value of the land at the time the contract with the lien holder was made."

The court's interpretation was driven by three observations on

the language of Section 16. First, "the time of making the contract" refers to the dates of individual contracts for lienable materials and services, and not the date of the mortgage. Because the contracts will have different dates, the mortgagee will have priority over different values vis-à-vis each contractor. In the absence of any pool of improvements that is constant for all contractors, over which they all have some potential priority, the statute only contemplates a contractor having priority over the proportional share of its own improvements. Second, the use of "improvements" in the plural could simply signify that any one contractor may construct multiple improvements on the property. "Improvements" cannot mean all improvements because lien claimants do not have priority on value that predates their contract. Third, since the statute references multiple lien creditors, "it is only logical that each claimant would have priority with respect to his own improvements."

However, given the court's own interpretive approach, it is still conceivable that lien claimants would have priority over their own improvements and would share proportionally with other lien claimants as to any latter-constructed improvements. As an example, assume there are five contractors, each starting its work after the previous contractor is done. If only the second and fifth contractors are fully paid, the first contractor would be entitled to a share of the value added by the second and fifth, but the third and fourth would only be entitled to share proportionally with the first contractor in the improvements of the fifth. The Court's example has the bank taking the second and fifth contractor's shares, which are off-limits to the unpaid first, third and fourth contractors. While the Court implicitly disapproved of creating "side pots" for the contractors to share in, the Court's reasoning leaves room for arguing such an allocation in future cases.

After sorting out the prior case law and determining that its opinion meshed with the majority of those cases, the court examined the purpose and consequences of the Mechanics Lien Act. The Act's purpose of "protect[ing] those who in good faith furnish material or labor for the construction of buildings," will be served by tying claimants' proportional shares to the material and labor that they actually furnish. If lien claimants were preferred to the value of improvements that they did not contribute, they "would be unjustly enriched, to the detriment of an owner or mortgagee who funded improvements other than those that form the basis for the liens. This would discourage lenders from lending more than the property is worth at the time the mortgage is issued, hindering developers' access to financing." Further, restricting the mortgagee's priority to recorded liens that it paid and thus became subrogated would result in an inefficient process of contractors to filing mechanics liens before being paid.

At this stage, the court had only affirmed the 1940 appellate decision in *Moulding-Brownell Corp. v. E.C. Delfosse Construction Co.*, 304 Ill. App. 491, 499. (1st Dist. 1940): The mortgagee had priority for the value of the land and the contractors had priority for the proportional value of their individual improvements. The court still had to determine the allocation of the value from the paid-for improvements. To begin this analysis, the court examined one of its decisions from 1872, *Clark v. Moore*, 64 Ill. 273 (1872).

In Clark, the court had held that "the enhanced value produced by the payment of money by the owner, whilst the work was progressing, should be applied to the satisfaction of the mortgages on the property; and if any portion of the fund thus created shall remain, to be applied to the satisfaction of the liens for labor and materials." The court had considered various ways of allocating proceeds when "there is a large proportion of the enhanced value of the property produced by the owner paying for labor and material furnished by others than the parties to the suit." It rejected the theory of having the value "appropriated to the payment of [mechanics lien claimants'] liens" as well as the theory of having such value "treated as a fund in which both [lien claimants and mortgagees] may participate pro rata."

The Clark case, unlike LaSalle, involved the individual owner himself actually paying the contractors who constructed improvements but did not pursue a lien. Interestingly, the court put the onus on the lien claimants as to why Clark should not automatically be extended to benefit mortgagees. The court could not "find a meaningful distinction between an owner paying the contractor from his bank account with presumably borrowed funds (given that all owners have a preexisting mortgage on the property when this statutory provision is in question) and authorizing the mortgagee to pay the contractor directly through a draw on the loan." Even though the payments from owners and mortgagees are "presumably not made for the benefit of other lien holders," it hardly follows that owners and mortgagees should be treated identically.

A somewhat more solid basis for the holding, albeit one deriving strictly from equity, is the LaSalle court's reading into Clark the understanding that "improvements paid for by the owner to property subject to a mortgage would presumably be paid for out of the proceeds of the mortgage, and therefore it is the mortgagee, not the lien holders, that should take priority with respect to the added value attributable to those improvements." It is curious, though, that the court ultimately rested upon this justification while putting subrogation aside and dismissing subrogation throughout the opinion.

Subrogation, however, was the issue with which Justice Garman, writing for the 5-2 majority, decided to conclude the opinion. LaSalle was indeed subrogated to a mechanics lien predating the mortgage because LaSalle paid off the lien, making LaSalle stand in the shoes of that contractor for purposes of priority. As to the trial court's decision to subrogate LaSalle to the value of the paid improvements rather than granting LaSalle priority under Section 16 of the Act, the court noted that the analysis and result would be the same.

Concluding the opinion, the Court described its holding as: "In a proportionality determination under section 16 of the Mechanics Lien Act, the value of the property attributable to improvements paid for with proceeds of a mortgage and construction loan should be attributed toward the satisfaction of the mortgage." However, the holding arguably goes beyond that characterization. First, the court confirmed that under Section 16, mechanics lien claimants have priority only over their own proportional share of the improved value of the property, in doing so overruling a Depression-era appellate case to the contrary. Second, the court also confirmed the holding in Clark that the improvements paid by an owner accrue to the benefit of the mortgagee. Third, the majority downplayed the importance of equitable subrogation in the priority analysis. Fourth, as the dissent pointed out, the holding benefits mortgagees such as LaSalle who continue to pay for improvements even after the owner is in default.

The dissent objected to both the practical effects and reasoning of the majority opinion. The primary objection, though, appears to be the practical effects: that the holding would give construction mortgagees "the equivalent of a mechanics lien claim" for amounts paid to contractors. The dissent also made the persuasive case that under Section 16, the value of improvements constructed by non-parties should be a non-factor, promulgating a new proportionality analysis. The numerator for each party's fractional share would be the amount directly attributable to that party (value of the land for mortgagees, value of the contractor's improvements for a contractor), and the denominator would be the sum of all amounts directly attributable to the parties. There is something to be said for the simplicity of this approach.

Regardless of the wisdom or workability of the dissent's proportionality analysis, though, the 5-2 split in LaSalle ensures that the majority's interpretation of Section 16 will govern

mechanics lien litigation for the foreseeable future. All practitioners of construction, real estate, and banking law should be aware of how the holding in LaSalle affects their clients rights and their own strategy and tactics in maximizing the value derived from those rights.

The primary practical result of LaSalle is that construction lenders have more security when funding draws on their loans. Ordinarily, issuing draws when a loan is in default is a losing option, but the additional security of an increased proportional share combined with the bank's option of buying the property at the sheriff's sale will tend to mitigate losses. If the bank plans to purchase the property, paying for improvements up front will accelerate completion of the project and make it marketable sooner. Under LaSalle, the purchasing mortgagee would recoup a portion of these post-default payments, thereby effectively finishing the needed construction at a discount. LaSalle is therefore quite the boon to lenders who intend to purchase the property at the foreclosure sale: the more improvements they fund, the more of the sale proceeds they recoup and the greater the amount of this "discount."

Contractors must be vigilant as to what improvements the lender is funding and what amounts are paid versus unpaid. It might be worthwhile for contractors to seek funding directly from the lender since both sides may benefit: the lender adds the contractor's contributed value to the value of the lender's improvements and removes a potential adversary, while the contractor gets paid and saves litigation costs.

As far as litigating, the particular facts of LaSalle do not provide much insight into strategy, since no party appealed the court's using the contract method of determining value. Once the contract amounts are accepted, determining fractional shares and priority is simply a matter of applying the formula and priority rules as expressed in the majority opinion.

However, things get interesting if not all parties agree on the valuation method. The majority opinion mandated certain priority rules but did not mandate that the contract method be used to the exclusion of market value. Given that mortgagees now have a stake in the improvements on many projects, the valuation of those improvements may be more contentious. The additional litigation costs associated with valuation may make settlement a more attractive option.

Depending on the fractional value contributed by the lender-paid contractors, it may be worthwhile for mechanics lien claimants to seek the market approach to valuation in order to dilute the fractional share held by the lender through its having financed other, possibly unfinished improvements. On the other hand, a contract-based valuation may inflate the bank's portion of the improvement value but increase the claimants' portion thereof to an extent to make contract valuation a better option for the claimants. Attorneys must be aware of how LaSalle affects their clients' interests in maximizing their proportional share from a sheriff's sale, and must also bear in mind how LaSalle affects other litigants' incentives with regard to valuation.

The Court's ruling in LaSalle is certainly momentous, altering the relationship between mortgagees and contractors, as well as altering the business and litigation decisions of each. It establishes clearly-defined rules on priority and removes the ambiguity previously inherent in a mortgagee's decision to pay contractors directly. If the Supreme Court is willing to resolve such questions, it may soon be faced with the loose ends from the LaSalle opinion—namely, the continuing role (if any) of subrogation, whether lien claimants may share proportionally in "side pots" to the exclusion of the lender based on work completed after the lender-paid contractors' work, and the impact of its ruling under market-value cases. Practitioners should keep these loose ends in mind to distinguish, limit, or expand on LaSalle as may be necessary for their clients.

David McArdle is a named partner in McHenry County's largest law firm, Zukowski, Rogers Flood & McArdle in Crystal Lake. McArdle practices in construction law, commercial litigation, real estate and zoning, he represents a number of local units of government and has also been successful in a number of personal injury plaintiff's suits. He is the former chair of the Local Government Section Counsel of the ISBA. In addition he is an adviser to the Illinois Road and Transportation Builders Association and its members on construction-related matters and is the author of Construction Law Road Map, a regularly updated handbook for contractors and small business owners. He received his A.B. from Indiana University in 1978 and his J.D. from John Marshall Law School in 1981.

Gregory J. Barry is an associate at Zukowski, Rogers Flood & McArdle.

Leading Lawyers Network℠
Find a better lawyer, faster℠

This article originally appeared in *Chicago Daily Law Bulletin's Law Day Edition* and has been reprinted with permission. © 2011 Law Bulletin Publishing Co.