On July 16, 2014, Illinois enacted Public Act 98-764 (Senate Bill 3023) (“SB 3023”), which amends the Illinois Mechanics Lien Act (770 ILCS 60/ et seq.) (the “Act”) to prohibit subordination of mechanics liens on Illinois construction projects, unless such subordination is to a construction mortgage lien made after 50% of the construction loan has been disbursed to fund construction costs.

SB 3023 represents continuation of a multi-year dispute in the Illinois legislature that arose from the Illinois Supreme Court’s decision in LaSalle Bank N.A., v. Cypress Creek, 242 Ill. 2d. 231 (2011). In Cypress Creek, the Illinois Supreme Court held that under the value “enhancement” provisions of Section 16 of the Act, a mechanics lien claimant in a foreclosure proceeding was only entitled to lien priority to the extent that each such mechanics lien claimant’s work improved the property. In such case, a construction mortgage lender would receive “credit” for the value of work performed at the property which had been paid for using loan funds, thereby granting the construction mortgage lender the benefit of having made such payments.

The Cypress Creek decision set off a heated debate between Illinois construction lenders and contractor and subcontractor groups, which resulted in the passage of
Public Act 97-1165 (House Bill 3636) ("HB 3636") on February 11, 2013. HB 3636 amended Section 16 of the Act to reverse the Cypress Creek decision and provided that the mortgage lender in a foreclosure proceeding will have a lien on the foreclosure proceeds in the amount of the value of the unimproved land at the time the contract for construction was entered into, and that all mechanics lien creditors will have a lien on the foreclosure proceeds in the amount of all subsequent improvements to the property.

As a result of HB 3636, Illinois construction lenders began searching for a new method to protect their interests in construction projects, as HB 3636 left them exposed to claims for lien amounts for work already paid for using construction loan funds. One method that construction lenders began to consider was a subordination agreement providing for subordination of lien rights to the lien of the mortgage. While Section 1(d) the Act prohibited so called “no-lien contracts” where an agreement to waive lien rights was a condition to entering into the construction contract, Sections 1(d) and 21(b) of the Act allowed subordination of lien rights, so long as the construction contract and all subcontracts clearly set forth the subordination provision in writing.

In response to such subordination agreements, legislative allies of contractor and subcontractor organizations introduced SB 3023 in the 2014 Illinois legislative session. As introduced, SB 3023 originally prohibited subordination of mechanics lien rights as void against public policy and unenforceable. As finally enacted, however, SB 3023 attempts to give construction lenders a method to attain some measure of subordination protection. Under the final SB 3023, Section 1(d) of the Act was amended to prohibit agreements to subordinate mechanics lien rights, excluding “an agreement to subordinate a mechanics lien to a mortgage lien that secures a construction loan if that agreement is made after more than 50% of the loan has been disbursed to fund improvements to the property.” Therefore, a construction lender can achieve the protection offered by subordination of mechanics lien rights, but must wait until half or more of its construction loan proceeds have been disbursed.

SB 3023 also amended Section 21(b) of the Act to provide that subcontractors may be subject to the subordination agreement if the contract between the contractor and subcontractor expressly provides for such subordination. However, the language used in Section 21(b) is not consistent with the language used in Section 1(d), so caution is advised in relying on such language absent further clarification from the legislature or the courts.

For Illinois contractors and subcontractors, SB 3023 represents a continuation of Illinois legislative activity that over the past few legislative sessions has provided further protection to mechanics lien claimants. For construction lenders, SB 3023 creates a potential alternative method to protect their mortgage lien priority; however, given the potential administrative burden of ensuring that (1) a subordination agreement is entered into after the time that 50% of construction loan proceeds have been disbursed, and (2) each construction contract, including all subcontracts and material supplier purchase orders contain the requisite subordination language to ensure that every potential lien claimant has agreed to subordinate, one wonders whether the subordination exception included in the Act...
will ultimately prove to be of much use to construction lenders.

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