

TITLE ISSUES

RESIDENTIAL NEW CONSTRUCTION The Statutory Payment Scheme

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When buying a newly constructed home, one of the greatest fears for the buyers and their attorneys are mechanics' liens. When signing a contract to build a new home, a contractor, his subcontractors (trades), and material suppliers have concerns about getting paid. When lenders undertake a construction loan to build these homes, they are concerned that their funds might lose priority to mechanics' liens. How may these concerns be alleviated? Through trial and error and many pendulum swings, Illinois has today what is known as the Illinois Mechanics' Lien Act, 770 Illinois Compiled Statutes, 60/1-60/39. The Act and the ensuing case law seek to provide a balance among the competing interests. The Chicago Title Insurance Family of Companies (CTI) have been in the business of providing title insurance to new homeowners and lenders for almost 150 years. CTI's system of policies, endorsements, and documentation procedures have been tested and proven. This article will focus on the documentation required to issue policies free and clear of mechanics' liens in residential new construction, specifically 1) the statutory payment system, and 2) the case law interpreting and supporting this system.

What is the problem?

Examples here may provide insights into the concerns the owner, contractor, and lender face:

EXAMPLE A:

Ms. Jones purchases a vacant lot. She enters into a contract with Burley & Bright Construction Company to build her dream home. She arranges a construction loan with a reputable lender.

Construction is finished and Ms. Jones moves in. A short time later she applies for an equity line loan and finds a lien against her property by Mr. Subcontractor. Ms. Jones paid all the money required by the original contract.

EXAMPLE B:

Mr. Developer hired Mr. Contractor to build a home. Prior to the final phase of construction Mr. and Mrs. F. T. Buyer enter into a purchase contract with Mr. Developer. Mr. Developer conveys the house to Mr. and Mrs. F. T. Buyer who receive a notice of lien from Mr. Contractor.

How could the risk inherent in these situations have been minimized? What is the crux of the problem? Obviously someone provided labor, services or material to build a house, for which they claim they have not been paid. The trades in the foregoing examples apparently did not get paid for the work they have performed or the materials they have supplied. Pursuant to the Mechanics' Lien Act, they have a lien against the property. If the trades properly perfect their lien by sending notice, recording, and/or filing suit in a timely manner, they may foreclose against the property. If Ms. Jones and Mr. and Mrs. F. T. Buyer did not obtain the necessary statutory documentation, they may end up paying twice for the claimed lien - once under the original contract payments and again to stop the foreclosure should it proceed.

The lenders of Ms. Jones and Mr. and Mrs. F. T. Buyer of the foregoing examples could lose the priority of their mortgage liens. The contractor's and

subcontractor's claim come into being as an inchoate lien at the time of the execution of the original contract between the owner and the original contractor to perform the work. Therefore, the lien of a contractor and subcontractor has priority as to the land and improvements over all subsequent liens which may be placed against the property. If the mechanic's lien claim comes into being prior to the recording date and disbursement of funds of the mortgage, the mechanic's lien will have priority over the mortgage as to land and improvements.

Statutory Scheme.

If the buyers and lenders had utilized procedures under the Illinois Mechanics' Lien Act designed to protect them, they would be able to assert a statutory payment defense. Let us analyze the Act with attention to sections relating to payment.

Section 5 of the Act, relating to contractors reads:

"It shall be the duty of the contractor to give the owner, and the duty of the owner to require of the contractor, before the owner or his agent, architect, or superintendent shall pay or cause to be paid to the contractor ... a statement in writing, under oath or verified by affidavit, of the names and addresses of all parties furnishing materials and labor and of the amounts due or to become due to each."

Section 22 for subcontractors reads as follows:

"Any subcontractor shall, as often as requested in writing by the owner, or contractor, or the agent of either, make out and give to such owner, contractor or agent, a statement of the persons furnishing material and labor, giving their names and how much, if anything, is due or to become due to each of them, and which statement shall be made under oath if required."

Prudent purchasers and lenders will obtain lien waivers from the parties disclosed in the sworn statements. Although obtaining waivers is not a statutory requirement, getting partial and final waivers is extremely important. They are evidence that the trades have given up their rights to a lien against the land or any right for payment by the owner. A final waiver is the intentional relinquishment of a legal right, which in this instance, relinquishes any right to further payment and lien rights

as to the land and improvement. Chicago Title's lien waiver forms include a Section 22 affidavit.

If payments are made pursuant to Sections 5 and 22 affidavits and no statutory notices are received from subcontractors claiming greater amounts, the owner is a winner.

Section 21 reads:

"In no case, except as hereinafter provided, shall the owner be compelled to pay a greater sum for or on account of the completion of such house, building or other improvement, than the price or sum stipulated in said original contract or agreement, unless payment be made to the contractor or to his order, in violation of the rights and interests of the persons intended to be benefitted by this act"

However, the owner is not the only winner. Remember, the owner wants a home without mechanics' liens and the trades want to get paid. Section 21 provides for liens as follows:

"But where the contractor's statement, made as provided in Section 5, shows the amount to be paid to the subcontractor, or party furnishing material, or the subcontractor's statement, made pursuant to Section 22, shows the amount to become due for material, or notice is given to the owner, as provided in Sections 24 and 25 [notice of lien], and thereafter such subcontract shall be performed ... then ... such subcontractor shall have liens therefore to the extent of the amount named in such statements or notice."

The Case Law.

When disbursing funds through a construction escrow or insuring over a new construction exception, CTI requires, as a matter of policy, a general contractor's sworn statement (Section 5 affidavit) and final waiver of lien supplied by the general contractor, subcontractors, and/or material suppliers, among other requirements. The documentation is a prerequisite to disbursement of construction escrow funds and to the issuance of an owner's policy to the purchaser and a loan policy to the lender.

The essence of CTI's disbursement scheme rests upon the foregoing statutory payment scheme as interpreted by case law. The following cases are the

basis for understanding the scheme, and hence form the cornerstone for documentation requirements.

In *Deerfield Electric Co., Inc. v. Herbert W. Jaeger & Associates, Inc.*, 74 Ill. App.3d 380 (1979), the court held that statutory documentation requirements are an implied portion of each and every construction contract. In Jaeger the court further held that the contractor lost his lien rights when he refused to submit a Section 5 affidavit as requested by the lender, here the owner's agent.

In another case, *Fred C. Kramer v. LaSalle National Bank*, 36 Ill. App.2d 406 (1962), the contractor submitted an affidavit to the owner. However, the affidavit did not meet the requirements of Section 5. The owner paid out the contract amount. A material supplier surfaced and perfected his lien. The Court held the subcontractor had a valid lien because the affidavit was not "...a statement in writing, under oath or verified by affidavit, of the names of all parties furnishing materials and labor, and of the amounts due or to become due each."

The most important case is *Sanaghan v. Lawndale National Bank, et al.*, 90 Ill. App.2d 254 (1967). The owner received a Section 5 affidavit from the general contractor. The owner paid all monies pursuant to the affidavit. However, an omitted subcontractor surfaced and perfected according to the statute. The notice of lien was sent to the owner subsequent to the final payment. The Court ruled that since the owner obtained and paid out in reliance upon a proper Section 5 affidavit, and the subcontractor had failed to give the owner timely notice, the subcontractor had no lien rights against the property.

The lien waivers are important in that the waiver is an affirmative relinquishment of rights the trade may have pursuant to the Mechanics' Liens Act. Waivers may be final, partial or conditional. Final waivers refer to labor or material supplied ... "heretofore and hereafter..." A partial waiver relinquishes lien rights either to a specific date, usually the date of a Section 5 affidavit, or to a specific amount. CTI, because of insurance coverage, primarily requires to date waivers and final waivers. Conditional waivers are unacceptable because

insurance coverage must be as specific as possible and reliance cannot be dependent on a condition subsequent.

Conclusion

Chicago Title relies upon the Mechanics' Lien Act in providing coverage for new construction. The basic requirements are General Contractor's Sworn Statements and submission of lien waivers, the cornerstones of coverage, as reinforced by case law. If the owner pays honestly and according to the rules of the Act, he wins. If the trades follow the rules, they have a means of securing payment for labor and materials they have supplied, and they win. When the statute is followed and funds are paid, CTI can insure owners and lenders over mechanics' lien claims on new construction. The payment scheme provides CTI with the framework within which it can exercise prudent underwriting practices.