



BOND IN LIEU OF PROPERTY SOMETHING NEW IN MECHANICS LIEN LAW

By Douglas M. Karlen
Vice President & Regional Counsel
Chicago Title Insurance Company
October 2015

Recent legislation creates a new concept in mechanics lien law, namely, a bond in lieu of property. Public Act 99-178 (HB 2635), effective January 1, 2016, adds new Section 38.1 to the Mechanics Lien Act to permit the substitution of a surety bond in lieu of real property in the context of the enforcement or possible enforcement of mechanics lien claims. See new 770 ILCS 60/38.1. By shifting the focus of mechanics lien litigation from the subject real property to the proceeds of a surety bond, the new Section allows owners to refinance construction loans or to sell newly constructed condominium units, single family homes, and commercial developments free and clear of mechanics lien claims.

How does it work?



THE PETITION TO SUBSTITUTE A BOND FOR PROPERTY

The best way to approach the substitution of a bond for real property under the new Section is to consider the traditional questions: who, what, where, when, and how.¹

1 The “why” question may not matter

WHO?

The Section uses the word “applicant” to define who may substitute a bond for real property. An applicant means:

- An owner,
- Another lien claimant,
- A party holding an interest in the property in question, e.g., a mortgagee,
- A condominium association or homeowners association, or
- Any person who may be liable for the payment of the lien claim, including an owner, former owner, condominium association, homeowners association, contractor, or subcontractor.

See 770 ILCS 60/38.1(a)(1).²

WHAT?

An applicant may file a petition to substitute an eligible surety bond for real property subject to a lien claim. The

when we speak of a statute.

2 Title companies are not included within the definition of “applicant.”



Section provides a lengthy definition of an eligible surety bond at 770 ILCS 60/38.1(a)(2).³ The Section defines an eligible lien claim as a claim, excluding interest and attorney's fees, on account of:

- A Section 24 notice that has been served on owner and lender,
- A recorded mechanics lien claim, or
- A pending suit to foreclose a mechanics lien claim, by way of complaint or counterclaim.

See 770 ILCS 60/38.1(a)(3).

WHERE?

An applicant may file a petition to substitute an eligible surety bond for real property subject to a lien claim with the clerk of the circuit court for the county in which the real property is located. If there is a pending action to foreclose the lien claim (by complaint or counterclaim), then the applicant must file the petition in the proceeding to foreclose the lien claim. See 770 ILCS 60/38.1(c).

WHEN?

If there is no pending proceeding to foreclose the lien claim, the applicant may file the petition any time after becoming

aware of the lien claim. If there is a pending proceeding to foreclose the lien claim, then the applicant must file the petition in the proceeding any time before five months have elapsed since the filing of the complaint or counterclaim. See 770 ILCS 60/38.1(c).

HOW?

The Section does not contain a form petition but does state that the following matters must be included in the petition:

1. The name and address of the applicant and the applicant's attorney, if any;
2. The name and address of the lien claimant;
3. If there is a pending foreclosure, the name of the lien claimant's attorney of record or, if there is no foreclosure, the name of the preparer of any recorded mechanics lien claim;
4. The name and address of the owner of record of the subject property or the name and address of a relevant condominium association or homeowners association;
5. The legal description and common address of the subject property;⁴
6. A copy of the recorded mechanics lien claim if there is no pending foreclosure;
7. A copy of the proposed eligible surety bond;
8. A certified copy of the surety's

³ Significantly, the bond must be in an amount equal to 175% of the amount of the subject lien claim. Also, the Section does not require the bond to specifically identify the lien claim, but best practice should dictate that the bond recitals identify the lien claimant, the lien claim, and any pending proceedings to enforce the lien claim.

⁴ The Section does not require inclusion of the permanent index number (PIN). Sound practice suggests the PIN should be included.



certificate of authority from the Illinois Department of Insurance or other agency charged with issuing such a certificate; and

9. An undertaking by the applicant to replace the bond with another eligible surety bond if the proposed original bond ceases to be an eligible surety bond.

See 770 ILCS 60/38.1(c).



PROCEEDING ON THE PETITION TO SUBSTITUTE A BOND FOR PROPERTY

After filing a petition, the applicant must send notice, by personal service or certified mail, to all persons identified in the petition (including their attorneys of record in any lien claim foreclosure action). The notice must include a copy of the petition and a form that is set out in the Section. The form advises the recipient that objections to the petition must be filed within 30 days of service or within 33 days of certified mailing, whichever occurs sooner. The form further advises that if there are no objections, then an order will be entered “substituting the security of the bond for the property securing the lien claim and discharging the property described in the petition as being subject to the lien, . . .” As a result of such an order, the lien claim is lifted from the real property and also from the moneys or other considerations due or to become due from the owner to the contractor under the original contract that gave rise to the lien claim. The lien claim will only be enforceable against the

proceeds of the eligible surety bond. See 770 ILCS 60/38.1(d).

If there are no timely objections, and if the applicant has otherwise complied with the Section, and if the court finds that the proposed surety bond is an eligible surety bond as defined in the Section, then the court shall enter an order:

1. Substituting the eligible surety bond for the property subject to the lien claim; and
2. Substituting the lien claimant's right to recover on the bond for any remedies against the property.⁵

See 770 ILCS 60/38.1(e).

If timely objections are filed, the applicant may notice up the matter for a hearing. There is only one issue that must be determined at the hearing—whether the proposed surety bond is an eligible surety bond as defined in the Section. If the court finds that the proposed bond is an eligible surety bond, then the court shall enter an order identical to the order noted above. See 770 ILCS 60/38.1(f).

In either event, after the entry of such an order, the applicant must:

1. Send copies of the order to all persons identified in the petition or who have appeared in relevant foreclosure proceedings; and

⁵ The Section does not require the order to recite certain relevant facts, such as the recording information for the subject mechanics lien claim. In addition, we have identified another deficiency in the Section. It does not say when and to whom the actual surety bond is to be delivered.



- Record a copy of the order, together with an executed copy of the approved surety bond, with the Recorder of Deeds for the county in which the real property is located.

See 770 ILCS 60/38.1(g).

Once a surety bond is approved by court order, the bond principals and sureties are the only necessary parties in any lien claim foreclosure proceedings. All other parties, e.g., owners, lenders, subsequent purchasers, other lien claimants, etc., may be dismissed. See 770 ILCS 60/38.1(h). The lien claimant may recover from the principals and sureties to the same extent as if no bond had been approved, subject, however, to the face amount of liability on the bond. See 770 ILCS 60/38.1(i). The principals and sureties may only assert defenses available to the principal on the bond (e.g., owner, former owner, mortgagee, etc.) or defenses that would otherwise be available to whoever was the record owner at the time the original (general) construction contract was let. See 770 ILCS 38.1(j). If an approved bond ceases to be an eligible surety bond, the original applicant is required to obtain a court order substituting a new eligible surety bond. See 770 ILCS 60/38.1(k).



THE TITLE COMPANY PERSPECTIVE

Chicago Title Insurance Company is prepared to rely on a court order substituting a bond for property under new Section 38.1. If we encounter a recorded court order substituting

a surety bond for property (with an accompanying copy of the bond), we will waive title exceptions for any mechanics lien claim identified in the order and on the bond. Further, we will also waive title exceptions for any foreclosure proceeding identified in the order and bond.

If, however, we find no court order and bond of record and a title commitment shows title exceptions for recorded mechanics lien claims, with or without accompanying litigation, we may offer the customer the following choice (bearing in mind that new Section 38.1 does not create a mandatory procedure):

- We may insure over the mechanics lien risk by endorsement based on a title indemnity deposit of at least 150% of the amount of the lien claim; the title indemnity may be funded by cash, letter of credit, or surety bond;⁶ or
- We may delete all title exceptions relating to the lien claim if and when the customer obtains and records an order substituting an eligible surety bond for the property.

Each clearance method has its own unique advantages and drawbacks.

For example, the title indemnity approach is a quick solution. It can be used to facilitate a closing or a construction draw. On the other hand, the

⁶ We will agree to the termination of such a surety bond if and when an eligible surety bond is approved by court order under Section 38.1.



title indemnity funds and the indemnitor's obligations may be tied up for years, as mechanics lien litigation tends to drag on through discovery, trial, appeal, etc. Further, we are obliged under Company guidelines to show the title exceptions and insure over them by endorsement—ALTA 34-06. Subsequent lenders or purchasers may balk at accepting title insurance policies in this form. We may suggest that if, post-closing or post-draw, the customer obtains and records a court order substituting an eligible surety bond for the property, we will settle the title indemnity obligation, release funds back to the indemnitor, and insure future draws or future policies free and clear of exceptions for the subject mechanics lien claim.

contains significant provisions relating to attorney fees for prevailing parties. These provisions should be carefully studied before filing a petition to substitute a bond for property. We urge our customers to read Section 38.1 in its entirety before attempting to utilize its procedures. The full text of Public Act 99-178 may be found on the Illinois General Assembly's website at www.ilga.gov.

For additional #CTtalk articles, visit the News & Events page on our website at:
www.ChicagoNCS.ctic.com

We welcome your topic suggestions for future #CTtalk issues. If you are interested in submitting your ideas, please email us at:
Annie.Bardelas@ctt.com.

In comparison, the bond approach may take longer to complete. With required notices and hearings, it may take several months to accomplish. Once a court order is obtained and recorded, however, we will waive all title exceptions relating to the lien claim identified in the recorded order or in the recorded bond, provided we are furnished evidence that the approved bond was delivered to the clerk of court. Because the exceptions are waived, subsequent lenders and purchasers will not see any such exceptions or be required to accept insurance by endorsement.

Whether taking the title indemnity route or the Section 38.1 bond route, the choice is up to our customer. We will provide insurance under either option, as described above. In choosing the Section 38.1 bond route, however, our customers must carefully consider questions of strategy. For example, Section 38.1