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Stop Notice--Construction Loan Officer's Nightmare

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Stop Notice!—Construction Loan Officer's Nightmare

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"IT'S MONEY in the bank, man," might well be the language of one subcontractor to another when certainty of payment for work done on a private job is being discussed. The subcontractor is telling his friend that he has learned he can tie up construction funds right at their source—the lending institution which is financing the construction. He is talking about the loans in the process account for the job in question at the lending bank or savings and loan association. He can get at this money by filing a stop notice and perfecting it as prescribed by the Code of Civil Procedure.[1]

The statute that allows a subcontractor, laborer, or materialman to cause money to be earmarked for his benefit is section 1190.1(h) of the Code of Civil Procedure. This provision of the mechanics' lien law has recently become popular among subcontractors and materialmen. They have learned that there is a way for them to be paid even though the general contractor or the owner of the property has failed, quit, disappeared, or declared bankruptcy. They have learned that if they follow the prescribed procedures, they are able to thwart that seemingly impregnable party to the construction project—the lending institution.

California has enjoyed unprecedented growth since World War II. To keep pace with the housing demand, developers and builders have engaged and will continue to engage in "speculative construction."[2] This term is used among lenders and developers to denote the

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[1] A stop notice is a document which when served and perfected in the proper manner garnishes a construction fund for the benefit of a laborer, subcontractor or materialman. Such garnishment is the only security for payment available to such persons when they are engaged in constructing public improvements. In the case of private improvements the stop notice remedy is available in addition to a mechanics' lien. See CAL. CODE CIV. PROC. §§ 1190.1-92.1

[2] California's share of the total residential units constructed in the United States continues to increase each year. With 291,900 new dwelling units authorized last year, the Golden State accounted for one out of each five new homes in the entire nation. The 291,900 units authorized in California represent a 22% increase over the 1962 total. This is contrasted with an 8% increase nationally.

building project that is started by the developer for immediate sale, as opposed to the "on your lot deal" which an owner initiates for himself and not for sale to others. There is a high risk in speculative construction. Because of this high risk there have been many abandonments by developers and general contractors. Such abandonments leave contractors and materialmen unpaid and faced with the prospect of having their lien rights cut off by the foreclosure sale of the lender. Materialmen and subcontractors have searched for other remedies and have found the stop notice.

A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n[3] firmly establishes the right of the stop notice claimant to tie up loan funds in the hands of a lender as against all parties, including the lender, whether or not loan funds were due to the borrower-developer or his general contractor, and whether or not the work of improvement which is security for the lender's loan has been completed. This decision has far reaching effects on construction lenders. Lenders are now faced with these realities: (1) there is no safe way to make construction loan disbursements, (2) the construction fund can be stop noticed and, therefore, prove inadequate to complete the building improvements.

Lenders' Construction Loan Practice

Construction lenders make construction loans on the basis of the appraisal of a piece of land and a set of plans. The amount of the loan is limited by law to a percentage of loan to appraised value.[4] Generally the security for the loan must be a first lien on the property[5] and the amounts advanced are not allowed to exceed a stated percentage of the value of improvements completed prior to the advance.[6]

The lender protects its lien priority by requiring the borrower to

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The phenomenal increase in apartment construction in California during 1963 was largely the result of a continued rise in land prices in the larger cities and their peripheral areas. The already strong interest in joint ownership of owner-occupied multiple housing was intensified when the legislature gave the condominium concept legal status in California. According to the Economic Report of the Governor, there seems little question but that condominium multi-unit offerings will capture an increasing share of the California new housing market. PASADENA, CAL. SAVINGS & LOAN LEAGUE, CALIFORNIA SAVINGS & HOUSING 1964 DATA BOOK.

[3] 61 A.C. 790, 394 P.2d 829, 40 Cal. Rptr. 85 (1964).

[4] CAL. FIN. CODE §§ 7153-53.4 (savings and loan associations); CAL. FIN. CODE § 1227 (commercial banks).

[5] CAL. FIN. CODE § 7102 (savings and loan associations), CAL. FIN. CODE § 1227 (commercial banks).

[6] CAL. FIN. CODE § 7156 (savings and loan associations), CAL. FIN. CODE § 1227 (commercial banks).

furnish title insurance, usually in the form of an American Land Title Association policy of title insurance. The insurer can guarantee the priority of the lender's entire loan because the lender has obligated itself to make a series of advances as construction progresses and may do so even having actual knowledge of intervening liens.[7] Before issuing its title insurance policy the insurer will inspect the land to make certain no improvement has begun that might give mechanics' lien claimants priority. This inspection generally takes place on the morning of the recordation of the lender's security instrument. The lender has thus effectively protected itself against the priority of mechanics' liens.[8]

The developer-borrower usually signs a building and loan agreement and assignment of account. This instrument gives the lender authority to set up a loan-in-process account which will be used for the sole purpose of constructing the contemplated improvement. This fund, created by the borrower's assignment back to the lender, is usually disbursed by the lender in one of two ways: (1) on the progress payment plan, or (2) on the loan order plan or "voucher" system. Under either system the lender will attempt to make close inspections of the progress of the work. The aforementioned fund is the target of the subcontractor's and materialmen's stop notices.

Getting at the Fund

Having decided that the chances are good that he will not be paid on a particular job and that mechanics' lien rights are of doubtful value or will be eliminated, the subcontractor or materialman files a stop notice. Stop notices must be verified[9] and filed by registered[10] or certified[11] mail. The stop notice contains notice that the claimant has performed labor or furnished materials to the contractor or other agent of the owner; it states what was furnished, to whom it was furnished, where it was furnished, and the amount of the claim.[12] The notice is served on the manager of the branch of the institution where the fund is located.[13]

Institutions have the option of rejecting and usually reject unbonded stop notices. When a bond in an amount equal to 125 per

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[7] Fickling v. Jackman, 203 Cal. 657, 265 Pac. 810 (1928).
[8] CAL. CODE CIV. PROC. § 1188.1.
[9] CAL. CODE CIV. PROC. § 1190.1(b).
[10] CAL. CODE CIV. PROC. § 1190.1(*l*).
[11] CAL. CODE CIV. PROC. § 11.
[12] CAL. CODE CIV. PROC. § 1190.1(a).
[13] CAL. CODE CIV. PROC. § 1190.1(k).

cent of the claim accompanies the stop notice, the fundholder must withhold "sufficient money with which to answer such claim."[14] There is a procedure by which the institution may object to other than corporate sureties.[15] The bond secures payment of costs and damages in the event the owner, general contractor, or fundholder recovers judgment.[16]

There is no practical way for lenders to protect the construction loan fund or loans in process account from stop notices. Disbursement of the loan fund to a builder's control organization or to an escrow agent for disbursement is merely a delaying tactic since such transfer would undoubtedly fall within the purview of the last sentence of Code of Civil Procedure section 1190.1(h), which prohibits assignment of the fund to defeat a stop notice claim. Disbursement of the entire loan fund to the borrower or contractor would leave no fund to which stop notices could attach, but the lending institution will not release control of the fund until its security is assured.

The stop notice claim must be perfected if the claimant expects the fundholder to withhold money beyond the time mechanics' liens could have been filed, plus ninety days. An action must be filed to enforce payment of the claim,[17] and the code directs that such actions may be filed only during the ninety day period *following* the last day for the filing of mechanics' liens. This is a pitfall for the unwary, for the required filing time for actions on mechanics' liens is different; these must be filed within ninety days of the recordation of the mechanics' liens.[18] A notice that an action has been filed must be given to the fundholder within five days of the filing of the action. This notice must be given by personal service or by registered or certified mail to the manager of the institution where the fund is located.[19] Presumably, personal service of the complaint and summons on the lending institution, if done within five days of filing the action, fulfills this requirement. A failure by the claimant to file an action within the prescribed time results in the fundholder being required to deliver the funds to whomever they may be due.[20]

What if the stop notice claimant files an action but does not give the five day notice? Prudent lenders will rarely pay out funds with-

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[14] CAL. CODE CIV. PROC. § 1190.1(h).
[15] CAL. CODE CIV. PROC. § 1190.1(m).
[16] CAL. CODE CIV. PROC. § 1190.1(h).
[17] CAL. CODE CIV. PROC. § 1197.1(a).
[18] CAL. CODE CIV. PROC. § 1198.1(a).
[19] CAL. CODE CIV. PROC. § 1197.1(b).
[20] CAL. CODE CIV. PROC. § 1197.1(a).

held by stop notice if a notice has not been filed within the prescribed period. How does the lender know that an action has not been filed in some competent court? The mechanics' lien law places no duty on it to search the court records. Such situations cause lenders to seriously consider delivery of the withheld funds into court and the institution by the fundholder of an action in interpleader.[21]

With the first stop notice on file the stage is set for more subcontractors and materialmen to file their stop notices. When the word gets around a construction job that the developer-builder's position is shaky, or that he is having trouble obtaining disbursements from the lender, or that the job isn't passing inspections, the lender can expect a multiplicity of stop notices to be filed against the loans-in-process accounts. When there are more claims than there is money available, the code provides that a pro rata distribution shall be made among those claimants with valid claims without regard to priority among them as to the time their claims were filed or their actions commenced.[22]

Why Construction Lenders Are Concerned

The *A-1 Door* case affirmed the lower court's judgment that the entire construction loan fund was subject to stop notice claims, and not just that portion of the money that was due the developer-borrower or his contractor based upon the stage of completion of the project. The lending institution bargained for a completed building as its security when it made its loan. The operation of the stop notice law under the rule of the *A-1 Door* case will, in most instances of developer-borrowers' default during construction, result in outright loss to lending institutions.

Lending institutions are concerned. The stop notice statute uses the term "equitable garnishment" in referring to the effect of a stop notice claim on the construction loan fund. A garnishment is a claim of the creditor of one party on an existing debt owing to that party by the party's debtor, the garnishee. If there is no existing debt there is nothing to garnish. The construction lenders' view of a stop notice claimant's rights was, and is, that the stop notice claim attached only to funds in the lender's hands due the developer-borrower under the

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[21] CAL. CODE CIV. PROC. §§ 386-86.5. The lender may be able to get some relief if it follows this procedure because costs and reasonable attorney fees are provided for in the discretion of the court. CAL. CODE CIV. PROC. § 386.6. Courts have awarded such fees in stop notice cases. Hazelwood v. Weeks, No. 147031, Sacramento Superior Court, ————.

[22] A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 394 P.2d 829 40 Cal. Rptr. 85 (1964).

terms of the building and loan agreement and assignment of account. If construction had reached the stage where the third progress payment was due the developer-borrower, then, say the lenders, all funds up to and including the third payment would be subject to stop notices, but not the funds beyond the third payment. Furthermore, if the third payment had been disbursed prior to any stop notices having been filed, a stop notice would "catch" nothing because nothing would then be due the developer-borrower. This position of the lenders was rejected by the supreme court in *A-1 Door*. In holding that the entire building fund in the lender's hands was subject to stop notice claims, it referred to Code of Civil Procedure section 1190.1(c) which limits the owner's liability to stop notice claimants to the amount "due or to that which may become due" to the owner's contractors. The court said that the question had been determined in *Stettin v. Wilson*,[23] which held that even though no money was due the general contractor because of his default, a stop notice claimant could recover funds in the owner's hands that might have become due the general contractor had he not defaulted. The court then concluded, apparently by analogy, that funds in the hands of a lender should receive the same treatment as funds in the hands of an owner and that, just as a stop notice claimant's right to recover does not depend upon whether the owner owes anything to the contractor, so the stop notice claimant's right to recover does not depend upon whether the construction lender owes anything under its contract with the developer-borrower-owner or his contractor.[24]

The court should not have equated the different situations of an owner and construction lender in determining what funds are subject to "garnishment" of stop notice claims. The construction lender bargains for a certain piece of improved land as security for a loan to the owner. The owner agrees to put up the improvement and take the risks involved in building the improvement. It is his building, his profit, or his loss. The construction lender never contemplated a deal where its money could be fully disbursed to the limit of the stage of completion of the building and the remaining funds "garnished" by unpaid claimants. Yet the law now effectively shifts the risk of con-

[23] 175 Cal. 423, 166 Pac. 6 (1917).

[24] "Thus the use of the term equitable garnishment does not imply that the stop notice claimants' right to recover depends on the owners' rights under their contract with defendant [lender] . . . . The requirement that the fundholder withhold claimed funds applies not only when his contract calls for payment but even when it does not." A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 796, 394 P.2d 829, 833, 40 Cal. Rptr. 85, 89 (1964).

struction from owner to construction lender. Supporters of the present state of the stop notice law argue that the statute as now interpreted is entirely fair. They say that it is designed to protect mechanics and materialmen who enhance the value of the owner's property and the lender's security. This argument was recently echoed by the district court of appeal in the case of *Rossman Mill & Lumber Co. v. Fullerton Sav. & Loan Ass'n.*[25] It must be remembered that in many cases of trouble in a building project, the very people who are to be protected are often the same ones who helped the developer-borrower divert funds from the project through kickbacks, false vouchers, and other collusive arrangements. Do these people deserve protection at the expense of the lender?

Consider the position of the developer-borrower. If his calculations show that the speculative construction project will not show a profit, isn't he likely to throw up his hands and abandon the project? Work then ceases, at a time when the next progress payment is not yet due but subcontractors and materialmen have supplied the project with labor and materials. In this situation if the progress payments paid out earlier were all properly disbursed there should be enough money in the loans-in-process accounts to pay unpaid claimants and allow the lender to have the building completed. This rarely, if ever, happens. Vandalism occurs on halted construction; previous progress payments have usually been diverted to uses other than payment for labor and materials on the project. The net result is that the lender is faced with an abandoned project, a loans-in-process account insufficient to complete the project even if no claims were made against it, and the prospect of all or most of the fund being stop noticed. Of course the developer-borrower, when called upon to put his own money into the project, turns out to be positively impecunious. Lenders attempt to protect themselves against such abandonments and defaults by requiring separate guarantees of their loans, but the realities of realizing on such guarantees and the impracticability of following up such defaults with judicial foreclosure and possible deficiency judgment leave the lender with an unfinished project which must be finished with the lender's own money.

The use by the lender of the loan order plan or voucher system does not insure that funds in the loan-in-process account will be adequate to pay for the project. Diversion of funds by the developer-borrower or by his general contractor can also be made under the voucher system. Under the voucher system the lending institution pays each subcon-

[25] 221 Cal. App. 2d 705, 709, 34 Cal. Rptr. 644, 647 (1963).

tractor and materialman on the basis of an order which the latter obtains from the general contractor or owner. This is a certificate that the work was done and the materials delivered, and the subcontractor or materialman signs a lien release upon being paid. At first blush this system appears to give the lender the protection it seeks—a completed building for the money loaned. Actually it does not. The general contractor can and often does issue vouchers to subcontractors and materialmen from one project to pay for work and material that went into another project. The lender's construction loan inspector cannot be everywhere at once and misses the diversion. The general contractor intends that he miss it. The first project is left without the labor and materials scheduled for it. The general contractor orders other subcontractors and materialmen to bestow their labor and materials on the first project and then cannot pay. The result is that stop notices are filed on the first project, and the fund on the first project becomes inadequate to complete the building.

The very filing of stop notices tells the lender there are unpaid claimants, and the tendency of prudent lenders is to halt further disbursements out of fear of ultimate lack of funds to complete the project.

Lenders say that if the stop notice law were construed to compel lenders to withhold only funds due to the developer-borrower according to the stage of completion, the risk of loss caused by the diversions, schemes, and defaults of the developer-borrower would not fall solely on the lender. There would be funds remaining to bring the project to some semblance of completion and so allow the lender to keep faith with its depositors and investors.

A-1 Door *Gives Some Guidance*

While leaving some questions unanswered and leaving California construction lenders in a predicament as to safe loan fund disbursal, the supreme court in the *A-1 Door* case did settle some matters that had been uncertain. The *A-1 Door* case had the typical facts: three construction loans by defendant lender set up in loans-in-process accounts to be paid out under the progress payment plan in five payments; a borrower who defaulted; a cessation of construction after some progress payments were made; stop notices filed; mechanics' liens filed; insufficient money to pay claimants and to complete construction. Defendant lender sued in a cross-complaint for declaratory relief and named all parties interested in the fund. The mechanics' lien claimants who had not filed effective or valid stop notices asserted

a right to the funds on the theory of equitable lien.[26] The *trial* court declared that the fund should be used first to pay those with valid stop notice claims, and the lender and mechanics' lien claimants who had not filed stop notices would share the remaining funds pro rata. The *district court of appeal*[27] held that the stop notice claimants should be paid first, then the mechanics' lien claimants on an equitable lien theory, but that the lender should not share with the mechanics' lien claimants. Interest before judgment on the claims was held a personal liability of the lender by the trial court.[28] The rules laid down by the *supreme court* in the *A-1 Door* case are as follows.

(1) Stop notice claimants with valid claims perfected under Code of Civil Procedure section 1197.1 shall recover judgment for their claims or for their pro rata share of the fund. There is no necessity for a stop notice claimant to file a mechanics' lien. The court confirmed that the mechanics' lien remedy and stop notice remedy are independent and cumulative.[29]

(2) Mechanics' lien claimants who have not filed stop notices are not entitled to equitable liens on the loan funds. Recovery on this theory was urged based upon the decision in *Smith v. Anglo-California Trust Co.*[30] In that case mechanics' lien claimants were allowed equitable liens on loan funds. However, the lender in that case had the security it bargained for, as there were completed improvements. Furthermore, the *Smith* case held that an equitable lien could be granted only if the claimants showed that they were induced to supply labor or materials by the owner or lender in reliance on the existence of the loan funds. It is the writer's opinion that the construction industry is going to find the construction loan departments of lenders very tight lipped henceforth. One question left unanswered: As between the construction lender and a mechanics' lien claimant who *can* show reliance on a loan fund but who has not filed a stop notice where improvements are unfinished and the developer-borrower has defaulted, who has the higher right to the loan funds?

(3) The stop notice claimant's rights against the lender are merely that the lender withhold if the claimant has fulfilled the requirements

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[26] Smith v. Anglo-California Trust Co., 205 Cal. 496, 271 Pac. 898 (1928).

[27] A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 224 A.C.A. 490, 36 Cal. Rptr. 576 (1964).

[28] A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 798, 394 P.2d 829, 834, 40 Cal. Rptr. 85, 91 (1964).

[29] *Id.* at 795, 394 P.2d at 833 40 Cal. Rptr. at 88; *accord*, Diamond Match Co. v. Silberstein, 165 Cal. 282, 288, 131 Pac. 874, 877 (1913).

[30] 205 Cal. 496, 271 Pac. 898 (1928).

of the statute. Proof that the claimant put value in the improvements pursuant to valid agreement with the owner or general contractor must be made against the developer-borrower.

(4) A lender is personally liable on a stop notice claim only if it fails to withhold pursuant to Code of Civil Procedure section 1190.1(h).[31] The court in *A-1 Door* strengthened this rule by holding that where a lender has complied with stop notices by withholding proper amounts it cannot be held personally liable for interest before judgment.[32]

(5) The court held, however, that interest before judgment was a proper charge against the loan fund on the theory that the owner-borrower owed the interest to the claimant.[33] The court had a simple answer to the argument of the construction lenders that there should be no interest before judgment allowed on the ground that the lenders would not know how much to withhold. Withhold the amount of the claim or eighty per cent of the bond accompanying the claim. But how much should the lender withhold for interest before judgment? After stating that the loan fund was liable for interest before judgment, did the court then limit the claimant to the amount of his claim?[34] Probably not. The careful construction loan disbursement officer upon receiving a stop notice must now make a careful estimate of the ultimate disposition of the case and the fate of the project. Opinions differ, but lenders are withholding up to two years interest to answer stop notice claims.

Conclusion

Subcontractors and materialmen have a very strong remedy at their command to obtain payment for their labor and supplies. This remedy is a sword with two sharp edges. Its use on a particular project may plunge the project into chaos, or at least into serious delays. The remedy must be carefully attended by persons who know what they are about lest the garnishment be lost for lack of proper procedure.

Construction lenders are faced with the prospect of serious losses on uncompleted projects where the stop notice remedy is used. The lenders say that they are not developers and should not be forced to

[31] Calhoun v. Huntington Park Sav. & Loan Ass'n, 186 Cal. App. 2d 451, 9 Cal. Rptr. 479 (1960).

[32] A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 798, 394 P.2d 829, 834, 40 Cal. Rptr. 85, 90 (1964).

[33] *Id.* at 799, 349 P.2d at 835, 40 Cal. Rptr. at 91.

[34] *Ibid.*

step into the developer's shoes upon his default. Legislation to limit the liability of the construction loan fund to stop notice claimants is being sought by the construction lenders.[35] A fair legislative solution to the problem would be to make the construction loan fund liable to stop notice claims only to the extent the improvement is completed absent negligent disbursement by the lender. Such legislation would be consistent with the dictates of the Financial Code concerning permissible loan limitations for savings and loan associations.[36] The supreme court did not consider these statutes in *A-1 Door*, stating that there was no showing in the case that the loans exceeded the permitted percentages.

But for now, that subcontractor was right: "It's money in the bank, man!"

[35] In a letter to this writer Mr. W. Dean Cannon, Jr., Senior Vice President of the California Savings and Loan League stated: "[I]n our judgment the only real cure for the stop notice problem is legislation and the California League has been working in this direction."

[36] CAL. FIN. CODE §§ 7154-54.5, 7156.