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California Civil Code Section 3264 and the Ghost of the Equitable Lien

By Paul D. Gutierrez*

The construction of a work of improvement on real property usually requires the participation of many parties. If the developer of a construction project does not have the capital to finance the entire construction effort, the developer must borrow to complete the project. The construction lender, whose function in such an endeavor is to loan money at interest, usually requires as security for the loan a first lien on the real property itself. The owner of the property executes a deed of trust, arranging to subordinate other encumbrances, thereby providing the construction lender with the necessary security interest in the property. With the first deed of trust securing its loan, the lender places construction loan funds into a construction loan account, from which periodic disbursements are made as actual construction progresses.

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1. "Work of improvement" is broadly defined in Cal. Civ. Code § 3106 (West 1974): "'Work of improvement' includes but is not restricted to the construction, alteration, addition to, or repair, in whole or in part, of any building, wharf, bridge, ditch, flume, aqueduct, well, tunnel, fence, machinery, railroad, or road, the seeding, sodding, or planting of any lot or tract of land for landscaping purposes, the filling, leveling, or grading of any lot or tract of land, the demolition of buildings, and the removal of buildings. Except as otherwise provided in this title, 'work of improvement' means the entire structure or scheme of improvement as a whole." However, for reasons of simplicity this Article will address primarily the construction of buildings and other structures on real property.


3. "'Construction lender' means any mortgagee or beneficiary under a deed of trust lending funds with which the cost of the work of improvement is, wholly or in part, to be defrayed, or any assignee or successor in interest of either, or any escrow holder or other party holding any funds furnished or to be furnished by the owner or lender or any other person as a fund from which to pay construction costs." Cal. Civ. Code § 3087 (West 1974).

4. See generally Continuing Education of the Bar, California Mechanics' Liens and Other Remedies § 8.13 (1972); Lefcoe & Schaffer, Construction Lending and the Equitable Lien, 40 S. Cal. L. Rev. 439, 440 n.4 (1967) [hereinafter cited as Lefcoe & Schaffer].
The borrower of construction funds, if not a builder himself, engages a general contractor to construct the actual work of improvement. The general contractor, however, must in turn enter into separate contracts with materialmen who supply specific building materials such as lumber and insulation, and subcontractors who perform more specialized types of construction such as plumbing and electrical wiring. The method of disbursement agreed upon between the borrower and the lender, sometimes with the participation of the general contractor, varies in the construction industry. For example, under the voucher method, each subcontractor, laborer, and materialman bills the general contractor as work is performed. The general contractor in turn requests, by voucher or other procedure, that the construction lender disburse to the general contractor funds from the construction loan account to reimburse the general contractor's payments to the subcontractors and materialmen. After routine, periodic inspections to insure that construction is progressing in accordance with both the disbursement requests and the plans and specifications, the lender disburses monies to the general contractor.

If for some reason the general contractor fails to pay the laborers and materialmen for the work performed, specific statutory remedies are available. For example, subcontractors and materialmen may seek to foreclose a mechanics' lien directly on the real property itself and

5. The Civil Code defines “original contractor” as any contractor who has a direct contractual relationship with the owner of the real property. CAL. CIV. CODE § 3095 (West 1974). For the purpose of this Article, “general contractor” and “original contractor” are used interchangeably.

6. “Materialman” means any person who furnishes materials or supplies to be used or consumed in any work of improvement.” CAL. CIV. CODE § 3090 (West 1974).

7. “Subcontractor” means any contractor who has no direct contractual relationship with the owner.” CAL. CIV. CODE § 3104 (West 1974).


9. Id. See also Lefcoe & Schaffer, supra note 4, at 451.

10. “Laborer” means any person who, acting as an employee, performs labor upon or bestows skill or other necessary services on any work of improvement.” CAL. CIV. CODE § 3089 (West 1974).


12. The California mechanics' lien is explicitly recognized in the California Constitution, CAL. CONST. art. XIV, § 3, and is set forth in the California Civil Code, CAL. CIV. CODE §§ 3082-3153 (West 1974). In August 1976, the California Supreme Court acknowledged that the state's mechanics' lien law constituted a “taking” of property by state action which satisfied the procedural due process requirements of the fourteenth amendment of the
thereby encumber the land for the payment of money due. As a practical matter, however, the mechanics' lien can prove to be an ineffective remedy, because the construction lender usually has obtained a first deed of trust on the property as a condition of making the loan prior to the arising of the subcontractor's rights. A foreclosure on the lender's first deed of trust effectively eliminates all the mechanics' lien claims of the subcontractors and materialmen whose interests were perfected subsequent to the lender's deed of trust.

Mindful of the limited effectiveness of the mechanics' lien as a remedy, claimants may seek to assert a right directly to the construction loan fund set up by the lender for the purpose of paying construction costs. By serving a stop notice on the construction lender, accompanied by a sufficient bond, a claimant may require the lender to withhold funds from the construction account sufficient to pay the claim. Once the lender receives the bonded stop notice, it must withhold the specified loan funds under risk of personal liability.
Situations have frequently arisen, however, when a claimant has failed to serve a bonded stop notice on the lender and, after the time for such service has expired, nevertheless has attempted to assert some entitlement to monies in the construction loan account outside of the stop notice procedure. Too, some claimants have sought to enforce other legal or equitable rights to the construction loan fund in addition to enforcing a bonded stop notice.

The theories submitted by such claimants ultimately resulted in the California Supreme Court's acknowledgment in 1928 that claimants who have supplied their labor and materials to a project in reliance upon the existence of the construction loan fund may claim a lien in equity on the loan fund itself. Recognition of an equitable lien on the loan fund effectively rendered superfluous the stop notice procedure and encouraged many claimants to ignore the bonded stop notice as a method of obtaining money from the loan fund. Such claimants could usually obtain loan funds from the loan account by way of this equitable lien because most subcontractors and materialmen furnishing labor, equipment or materials to the construction project do actually rely, to some extent, on the existence of the construction loan fund.

The equitable lien doctrine flourished until the legislature amended the stop notice statute in 1967. The new provision, subdivision (n) of Code of Civil Procedure section 1190.1, ostensibly provided that the equitable lien could no longer be asserted against the construction loan fund and limited the remedies of claimants to the stop notice procedures provided by law.

Although this provision, now recodified as Civil Code section 3264, has received limited judicial analysis, some decisions addressing the statute contain confusing and superfluous discussion, which in turn gives many claimants hope that a remnant of the equitable lien survives. Indeed, litigants seeking to reach the loan fund include in their pleadings almost as a matter of course a variety of legal theories in

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addition to their mechanics' lien and stop notice rights. In addition to the equitable lien, these theories include claims of negligent disbursement of construction loan funds, negligent entrustment, constructive trust, and concealment of loan funds. Trial courts are frequently reluctant to dispose summarily of such theories at the pleading stage, with the result that the construction lender must prepare and meet at the pretrial stage each of the theories asserted. It is the contention of this Article, however, that the language of Civil Code section 3264 is unambiguous, and should be applied as such by the courts. Discussion of the statute's effect on the equitable lien requires review and analysis of the equitable lien as well as the language of the statute itself. The Article will then investigate the statutory history of Civil Code section 3264, discuss the few rulings on the statute and comment on the statute's strengths and weaknesses as a measure designed to legitimize and enforce the stop notice as the primary remedy to be asserted against the construction loan fund.

The Growth of the Equitable Lien

In the 1928 case of *Smith v. Anglo-California Trust Co.*, the California Supreme Court recognized a new remedy to be afforded lien claimants under certain circumstances. There, Smith purchased five parcels of real property, obtaining from a securities company a construction loan of $20,000 which he intended to use to improve the property. As security for the loan, Smith executed and delivered to the lender a first deed of trust covering the five parcels. Thereafter, the lender set up a construction loan account, from which periodic disbursements were made to Smith as the construction progressed. Shortly after the construction was completed Smith died and his widow became the administratrix of his estate; at that time, $4,090 of undisbursed funds remained in the construction loan account. Liens totaling approximately $5,663 for the value of labor and materials furnished but not paid for were filed against the property. The claimants demanded that the lender withhold from the undisbursed loan funds an amount sufficient to meet their claims.

Smith's administratrix instituted an action to recover undisbursed loan funds from the lender and the trial court upheld her entitlement to

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27. *See note 139 infra.*
29. *Id.* at 498-99, 271 P. at 899.
the money. The lower court also decreed that the lender's deed of trust was a first lien or charge on the real property and superior to the other claims.  

On appeal by several of the unsatisfied lien claimants, the supreme court, in determining which of the claimants were entitled to the undisbursed loan funds, observed that nothing in the agreement between Smith and the lender obligated the lender to assure that the funds advanced to Smith would be used to pay the laborers and materialmen. Consequently, the lender's disbursements to Smith created no liability on the part of the lender to the lien claimants, and any rights of such claimants to the undisbursed funds could not be based on a trust resulting from the terms of the construction loan agreement. Furthermore, the court commented, the claimants could not assert a right to the excess loan funds on a theory that they were third party beneficiaries of the loan agreement. Nonetheless, the court held:

We are of the view that the money remaining undisbursed in the building loan account opened in Smith's name by the [lender] should, in accordance with established principles of equity, be so charged. And this by reason of those special circumstances and conditions consisting of representations and conduct upon one side and of action founded thereon upon the other. That the lien claimants must have relied upon the fund to be advanced to Smith by the [lender], and not alone upon the individual capacity of Smith or their right to a last lien upon the premises, as a means of obtaining payment for their labor and materials, is supported by every reasonable inference deducible from the surrounding circumstances.

The court was persuaded by the particular facts of the case, observing that the work of improvement was completed in substantial compliance with the plans and specifications; that but for the existence of the loan the claimants would not have extended Smith credit for

30. *Id.* at 499-500, 271 P. at 900. On appeal, the supreme court agreed that the lender did have a first lien on the property by recognizing that the lender, under its agreement with Smith, became obligated to Smith for the full amount of the construction loan, described by the court as a sum certain rather than an undetermined or an optional amount. *Id.* at 500-01, 271 P. at 900.

31. *Id.* at 502, 271 P. at 901.

32. *Id.* In *Whiting-Mead Co. v. West Coast Bond & Mortgage Co.*, 66 Cal. App. 2d 460, 152 P.2d 629 (1944), the court held that where the construction loan agreement specifies that the loan funds are to be applied to payments for labor and materials, the funds are held by the lender in constructive trust for the benefit of the lien claimants. That trust relationship between the lender and the claimant creates a duty on the part of the lender to apply any remaining construction loan funds to the payment of claims for labor and materials regardless of whether the claimants seek to perfect their mechanics' lien claims by bringing an action thereon.

33. 205 Cal. at 502, 271 P. at 901.

34. *Id.* at 502-03, 271 P. at 901.
their labor and services and hence had a reasonable expectation of being paid from the loan funds; that the lender and Smith should both have known that their construction loan agreement "would constitute a material inducement to [the claimants] in supplying labor and materials."35 This situation constituted "special circumstances" which warranted the imposition of a lien, in equity, on the undisbursed loan funds in favor of the lien claimants.

The court ultimately concluded that the trial court should have ordered that the lender pay over to the appellants the undisbursed loan funds on a pro rata basis.36

The court in Smith recognized the importance of an equitable lien on construction loan funds as a method of granting relief to laborers and materialmen who might have otherwise gone unpaid for services and materials supplied to a construction project. The object of such a remedy was to prevent the lender or the borrower from being unjustly enriched by undisbursed loan funds at the expense of laborers and materialmen who parted with services or materials to improve real property.37

In Pacific Ready Cut Homes v. Title Insurance & Trust Co.,38 the supreme court, restating its holding in Smith, made clear its concern over the situation when, having induced materialmen or subcontractors to rely on the existence of the loan fund, the construction lender then reaped the sole advantage after default due to the increase in the value of its security. The facts of the case revealed that the owners of the property and a representative of the lender had informed the claimant that the construction loan funds had been obtained and represented that materials and labor would be paid for out of the loan fund.39 Consequently, the "justifiable reliance" of the lien claimants on the existence of the loan fund was clear and proved to be the keystone of the opinion.40 The court's ruling emphasized the combination of induced

35. Id.
36. Id. at 504, 271 P. at 902. In Hayward Lumber & Inv. Co. v. Coast Fed. Sav. & Loan Ass'n, 47 Cal. App. 2d 211, 117 P.2d 682 (1941), the court of appeal held that a claimant need not bring suit on his mechanics' lien claim to share in the pro rata distribution of unexpended loan funds. The enforcement of a lien in equity did not require that a claimant move to foreclose on that statutory remedy to be "among those persons having legally and satisfactorily established their lien claims." Id. at 213, 117 P.2d at 683 (quoting Smith v. Anglo-California Trust Co., 205 Cal. 496, 504, 271 P. 898, 902 (1928)).
38. 216 Cal. 447, 14 P.2d 510 (1932).
39. Id. at 451, 14 P.2d at 511.
40. Id. at 450, 14 P.2d at 511.
reliance and unjust enrichment:

The defendant mortgage company, having received the benefit of plaintiff's performance in the form of a completed building and therefore a more valuable security for its note, is not justified in withholding or appropriating to any other use money originally intended to be used to pay for such performance, and relied upon by plaintiff in rendering its performance. 41

The Smith and Pacific cases indicate that the doctrine of the equitable lien would be applied in situations attended by certain factual circumstances: 42 (1) the work of the improvement was completed; 43 (2) the value of the improvement subject to the lender's prior security interest at least equalled the loan amount; 44 (3) the claimant actually relied upon the loan fund in supplying his labor and materials; 45 and (4) retention of unexpected construction loan funds by either the lender or the borrower would amount to an unjust enrichment at the expense of the claimant. 46 Significantly, although in Pacific there was clear evidence of induced reliance, Smith indicated that even a tenuous showing of reliance would suffice. In that case, the court felt that the mere existence of the construction loan agreement, secured by an encumbrance of record, made it "reasonable to conclude that the mechanics' lien claimants . . . must have relied upon . . . the agreement." 47 Although the court in Smith based its conclusions on "representations and conduct," 48 no verbal assurances of payment from the loan fund were discussed; it was nonetheless held that the element of reliance was "supported by every reasonable inference deducible from the sur-

41. Id. at 452, 14 P.2d at 512.
42. See Comment, Security Transactions: Mechanic's Equitable Lien on Construction Loan Funds, 5 Santa Clara Law. 69, 70 (1964) [hereinafter cited as Security Transactions].
44. "In cases where there is no completed building, the only security the lender has for the undisbursed portion of its full loan commitment is the right to retain the undisbursed funds until it has the security for which it bargained. Depriving the lender of that right does not prevent unjust enrichment, if the cost of completing the improvements is equal to or more than that amount remaining undisbursed in the loan account." Security Transactions, supra note 42, at 72.
48. Id. at 502, 271 P. at 901.
runding circumstances." The Pacific court impliedly affirmed the adequacy of this showing by commenting that "[t]he distinguishing facts of the two cases are not, in our opinion, significant."

The scope of the equitable lien as expounded in Smith was later limited by the California Supreme Court in A-I Door & Materials Co. v. Fresno Guarantee Savings & Loan Association. In A-I Door, construction had been halted before completion of the improvement. The lender argued that the undistributed loan funds could be used either to reduce the borrower’s debt or to finish the work of improvement. While upholding the rights of the claimants who had served bonded stop notices, the Court denied recovery to equitable lien claimants who had only filed mechanics’ liens. These latter claimants had contended that by virtue of the filing of such mechanics’ liens, they had established their right to an equitable lien on the loan fund. Rejecting that argument, the Court held that a claim to loan funds by way of an equitable lien had to be supported by a showing of inducement and reliance on the loan account:

An equitable lien may be imposed on a construction-loan fund only if it is established that the borrower or lender induced the supplier of labor or materials to rely on the fund for payment. (Smith v. Anglo-California Trust Co., . . . Pacific Ready Cut Homes, Inc. v. Title Ins. & Trust Co. . . .) There is no evidence in the record of any reliance on the loan funds or of any inducement so to rely. Nor is there any evidence from which reliance may be reasonably inferred.

49. Id. at 503, 271 P. at 901. The court held that, absent a duty created by the loan agreement which obligated the lender to assure that loan funds were used to pay laborers and materialmen, such claimants could not gain access to unexpended loan funds by way of imposition of a trust relationship between the lender and the claimant with regard to the loan account. In 1944, however, the court in Whiting-Mead Co. v. West Coast Bond & Mortgage Co., 66 Cal. App. 2d 460, 152 P.2d 629 (1944), held that when such an obligation does arise from the loan agreement a trust is created. Id. at 464, 152 P.2d at 631. The lender must then hold the loan funds in trust for the beneficiaries of the loan agreement. Later in Ralph C. Sutro Co. v. Paramount Plastering, Inc., 216 Cal. App. 2d 433, 31 Cal. Rptr. 174 (1963), the court applied the Whiting-Mead rationale. "The lender having a completed structure, and its trust deed having priority over the claims of suppliers of labor and materials, the purpose of the trust with respect to the lender was accomplished. The lender had no right to the remaining funds. There, as in the present case, it was the duty of the trustee [lender] to apply the remaining funds to the unpaid claims for labor and materials used in the construction." Id. at 436, 31 Cal. Rptr. at 176.


51. 61 Cal. 2d 728, 394 P.2d 829, 40 Cal. Rptr. 85 (1964).

52. Id. at 731, 394 P.2d at 831, 40 Cal. Rptr. at 87.

53. Id. at 732, 394 P.2d at 832, 40 Cal. Rptr. at 88. In support of their position, claimants cited Hayward Lumber & Inv. Co. v. Coast Federal Sav. & Loan Ass’n, 47 Cal. App. 2d 211, 117 P.2d 682 (1941).
Thus, while the court compared its holding with the inference drawn by the Smith court, the "special circumstances and conditions" in that case amounted solely to the facts that a loan agreement had been entered into, and the lender's deed of trust was a recorded encumbrance on the property. Presumably, the A-1 Door court now found these facts insufficient to create an inference of inducement and reliance on the loan fund sufficient to recognize an equitable lien. Instead, by implication the court found that one factor necessary to show such reliance is substantial completion of the improvement, that is, that the lender, as in the Pacific case, will be unjustly enriched. The court distinguished the facts in A-1 Door from those in Smith. The Smith court had noted that the structures involved had been "completed in substantial compliance with the plans and specifications"; in A-1 Door, however, the work of improvement had not been completed and hence neither the lender nor the claimant received the object of its bargain. Thus, A-1 Door did not reject the equitable lien doctrine but rather limited the situations in which it would be recognized without a claimant's compliance with the stop notice requirements, to some degree thereby encouraging the use of the bonded stop notice as a remedy for laborers and materialmen. After A-1 Door, the filing of a mechanics' lien on the property did not by itself entitle a claimant to share pro rata in construction loan funds by way of the equitable lien.

Nonetheless, in 1965, the equitable lien doctrine received a broad endorsement by the California Court of Appeal in Miller v. Mountain View Savings & Loan Association. There the work of improvement was not completed because the claimant had stopped work when he did not receive payment for his labor and material. Upon learning that construction had halted, the lender applied the balance of the construction loan account against the balance due on the principal debt. By the time the lender received the claimant's unbonded stop notice, the assignment of funds had already occurred. Exercising its rights under a first deed of trust, the lender then foreclosed, purchased the property

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54. 61 Cal. 2d at 732, 394 P.2d at 832, 40 Cal. Rptr. at 88 (citations omitted).
56. Id. at 503, 271 P. at 901.
57. Id.
59. Id. at 1251.
61. Id. at 649-50, 48 Cal. Rptr. at 282.
62. Id. at 655, 48 Cal. Rptr. at 286.
at the foreclosure sale, and subsequently resold it at a profit more than sufficient to cover the plaintiff's claim.

The court ruled on three issues, two of which are important to our discussion: first, whether the lien claimant obtained a legal right to loan funds by the filing of a stop notice without a bond; second, whether the unbonded stop notice was sufficient for the imposition of an equitable lien in that amount against the loan funds.

The issue of the sufficiency of the filing of the unbonded stop notice was easily disposed of by the court. The opinion discussed at length the relative positions of the lien claimant, the borrower and the construction lender under mechanics' lien law, and noted as well that the stop notice and the mechanics' lien remedies are cumulative and independent of one another. Although the court recognized that public policy might militate against providing the unbonded stop notice claimant less protection than the bonded claimant, the statute then in effect, Code of Civil Procedure section 1190.1 subdivision (h), dictated that result:

The statutory remedy . . . is, however, in derogation of the generally acknowledged right of the lender to contract for a lien which is superior to the rights of lien claimants in the property. If his rights are to be cut down, and he is in effect required to make a forced advance, it must be done in the manner provided by statute and a bond must be furnished . . . . It is concluded that respondent's failure to file a bond precludes him from seeking relief under the statute.63

However, the court's ruling on the statutory sufficiency of the stop notice did not preclude the claimant's assertion of an equitable lien on the loan fund—the second substantive issue. The court stated that when the lender receives the benefit of the claimant's performance, thereby enhancing the lender's security, the lender is not justified in appropriating money originally intended and relied upon by the claimant for the payment of the claimant's performance.64 The fact that the lender had applied the loan balance against the principal prior to the receipt of the claimant's stop notice did not preclude the imposition of the equitable lien:

The statutory provisions invalidate as to a claimant an assignment whether made before or after a verified claim is filed. Assertion of the lender's rights by virtue of his contract with the borrower must await the running of the period in which claims may be filed, and they yield priority to such claims as are filed.65

63. Id. at 661, 48 Cal. Rptr. at 290.
64. Id.
Reliance upon the loan fund could not be supported by the mere filing of the mechanics' lien claim. Rather, the court held that there must be "direct evidence of inducement or reliance or other facts from which either reasonably may be inferred" before an equitable lien may be imposed.

The court then turned to the facts of the case. The lower court had found that the claimant had performed "in reliance upon the building and loan fund." The claimant was aware that the borrower had obtained the loan, but the details of the borrower's arrangements with the lender were unknown. The lender and the borrower had engaged Empire Builders Control as an independent company whose function was to disburse the loan funds. All disbursements and loan payments were made through Empire, and the claimant testified at trial that he expected to get paid because the matter was being handled by Empire. On this basis, the court affirmed the trial court's holding that an equitable lien existed in favor of the claimant:

The foregoing evidence permits the inference that Empire was used as some sort of escrow agent representing subcontractors and others furnishing labor and materials to the five lots, the owner, and the lender. Presumably Empire knew where the money was coming from, and the lender knew that those dealing with Empire were looking to it for payment. In setting up this system of making payments appellant can be charged with inducing reliance on the payments it would make, and respondent can be said to have relied on the payments to be made to its escrow agent by a financial institution, even though he did not then know its identity.

The court in Miller was not constrained to limit its ruling by the fact that the work of improvement was not completed; rather, the court justified the imposition of an equitable lien on the loan fund by observing that A-I Door "did not indicate that an equitable lien could not exist in the absence of a completed building." Too, the court rea-

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Miller Case: Claimant's Delight Lender's Fright, 41 L.A.B. BULL. 262, 265 (1966): "From this language the court held that a stop notice or equitable lien claimant will have priority over the lender's application of undisbursed loan funds to the loan whether such application is made before or after the filing of the stop notice or equitable lien claim. Thus the lender must wait until the expiration of the period for filing stop notices and equitable liens before knowing for certain that an assignment of undisbursed loan funds to reduction of the loan will not be set aside."

67. Id. at 649, 48 Cal. Rptr. at 282.
68. Id. at 663, 48 Cal. Rptr. at 291.
69. Id.
70. Id.
71. Id. at 664, 48 Cal. Rptr. at 292 (emphasis added).
soned that, because the Pacific court had refused to recognize a lender’s right to offset undisbursed loan funds against the principal loan amount, “[i]t is no great step to conclude that such offset should not be allowed even though the building is not complete . . . . All other factors being equal the rights of one contributing to the construction should not depend on the stage thereof at which his contribution was made.”

It is important to observe that the Miller court, by recognizing the right of an unbonded stop notice claimant to assert an equitable lien to the loan funds, attenuated to some extent the holding in A-I Door. The significance of compliance with the stop notice procedures provided by California law, noted in the A-I Door opinion, was substantially weakened by allowing the service of an unbonded stop notice on the lender to have the same effect as a bonded stop notice for the purpose of imposing an equitable lien. By so holding, Miller wedged the equitable-lien doctrine more firmly into mechanics’ lien law.

Miller left many issues unresolved. One commentator observed that the opinion left unanswered questions of what evidence will support an equitable lien and what procedures must be followed to perfect an equitable lien. The author also suggested that the case had neglected specifically to address whether the bonded, stop notice claimant had priority over the equitable lien claimant. He concluded that an equitable lien was most probably subordinate to a bonded stop notice, although superior to the right of a construction lender to apply unexpended loan funds to complete the structure or reduce the balance of the main debt after default.

In sum, the cornerstone of this series of decisions upholding the concept of the equitable lien on unexpended loan funds has been reliance on a construction loan fund. Inducement has been found on a wide array of facts. In Smith, reliance was demonstrated merely by virtue of the fact that a construction loan agreement had been entered into. In Pacific, the requirement was satisfied by representations made to the claimant by both the owner and representatives of the lender.

72. Id. The third issue presented to the court was the effect of the lender’s purchase of the real property at a trustee sale after foreclosure and the resale of the property at a substantial profit. Determination of this issue was precluded by the holding on the first two issues. Id. at 665, 48 Cal. Rptr. at 292.
74. Id. at 298.
75. Id. at 299.
76. See generally Annot., 54 A.L.R.3d 848 (1973).
Finally, in *Miller*, the creation of an arrangement whereby disbursements were made by an escrow agent known and expected to be the source of payment to subcontractors and materialmen was sufficient to infer induced reliance on the loan fund.

A sharp departure from this trend occurred in a case decided by the California Court of Appeal shortly after *Miller*. In *McBain v. Santa Clara Savings & Loan Association,*\(^77\) an equitable lien was created on the theory of reliance on the loan fund; but the court broadened this theory of recovery by declining to require that such reliance be induced by the lender. The facts indicated that the lien claimants had relied on the borrower's representations as to the expected source of payment, even though the lender was not alleged to have made representations.\(^78\) The court held the facts sufficient to impose an equitable lien in favor of the lien claimant:

We think that the equitable principles given recognition in *Smith, Ready Cut Homes* and *A-I Door* justify the conclusion that, where suppliers of labor or materials have been induced to rely on the loan fund by either the borrower or the lender, their equitable liens on the fund should have priority over the claims of both of such last mentioned persons to the fund. Basically it is the fund itself and the arrangement for progress payments therefrom, created by the mutual agreement of the borrower and the lender, that constitutes the material inducement to the subcontractors and materialmen.\(^79\)

A two-fold justification was offered for this result. The court reasoned, first, that the lender "had already protected itself with a first priority encumbrance on the property."\(^80\) Second, the lender controlled both the loan fund and disbursement of the progress payments; it was therefore in a "commanding position . . . to prevent the diversion or dilution of the progress payments by the owners to the prejudice of appellants."\(^81\) Given the lender's inspection of the property, the prerequisites for the disbursement of loan funds, and the lender's full control over the loan account, it could not be said that the lender might be unaware of the claimant's reliance on the loan fund. No equitable consideration, the court concluded, could justify the borrower's claiming priority over the claimants; hence, no equitable considerations dictated more favorable treatment to the lender.

It does not seem to us to be consonant with the philosophy expounded in *Smith* to grant still another prior lien on the loan funds

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78. Id. at 841, 51 Cal. Rptr. at 86.
79. Id. (emphasis in original).
80. Id. at 842, 51 Cal. Rptr. at 86.
81. Id. at 842, 51 Cal. Rptr. at 86-87.
themselves to such a lender-fund holder who despite its dominant position in the arrangements and its apparent sophistication in commercial financing had chosen not to protect its preferred position but would nevertheless claim the benefits that the labor and materials of others have contributed to the property.\textsuperscript{82}

The major impact of the \textit{McBain} holding is that the claimants were given priority to the unexpended loan funds over the lender even though they were not aware of the lender's identity and their only reliance was upon the borrower's representations. Whether equity required a lien in favor of the claimants no longer depended on precisely who had induced reliance on the fund, but on the fact that one of the parties to the "fund which existed by the joint acts and mutual agreement of both the owners and the lender"\textsuperscript{83} had done so.

In a strong dissent, Justice Sims argued that in the absence of some estoppel or unjust enrichment attributable to the lender, the law did not mandate that the lender pay over construction loan funds in a manner to which it did not agree.\textsuperscript{84}

Lefcoe and Schaffer\textsuperscript{85} likewise criticized what they describe as this "fault rationale." They point out that materialmen and others similarly situated have the means to prevent this type of loss;\textsuperscript{86} in addition, despite elaborate disbursal procedures, borrowers still appear able to misapply loan funds and thereby subject the account to equitable liens.\textsuperscript{87}

These commentators concur that equitable estoppel based upon reliance has been the foundation for the doctrine applied by the courts, and that such reliance has been easily inferred from even the most attenuated circumstances, on the basis of the respective relationships of

\textsuperscript{82} Id. at 842, 51 Cal. Rptr. at 87 (emphasis in original).
\textsuperscript{83} Id. at 843, 51 Cal. Rptr. at 87 (emphasis in original).
\textsuperscript{84} "The policy reasons for making the lender an insurer of payment to lien claimants are persuasive and attractive. The Legislature, however, by acting to create a system wherein a claimant may protect himself by giving a stop notice, has halted short of adopting this concept. The courts have been vigilant to protect the claimants where the lender has in any manner lead them to expect payment from him, but this case would plow fields heretofore left uncultivated. Since the lender must generally look to the land and improvements for repayment of his original advance and any amounts he is compelled to pay out to equitable lien-holders, the effect of the decision is to give a mechanic's lien claimant a priority over the lender with the first deed of trust, whenever he can show that the borrower—not necessarily the lender—induced him to rely on the loan fund." Id. at 848, 51 Cal. Rptr. at 90-91.
\textsuperscript{85} Lefcoe & Schaffer, \textit{supra} note 4.
\textsuperscript{86} Id. at 442, 446-49.
\textsuperscript{87} Id. at 442. The authors also suggest that the courts may be employing the concept of "allocation of resources" to place liability on the party best able to assess costs and insure against the loss, the construction lender; this allocation concept may represent the courts' perception that the threat of legal liability may change construction lending policy. Id.
the participants in the construction project.88 Thus, the equitable lien cases had the effect of making construction lenders sureties to such claimants to the extent that undisbursed loan funds existed when a project ceased.89 The natural consequence was, of course, that the construction lender in each case found itself subject to far more liability than that for which it had bargained. Because of the lender's inability to apply unexpended construction loan funds to the repayment of the principal debt until the rights to the equitable lien claimants have been determined, it thereafter had less incentive to make a construction loan without some protection that might be afforded outside of its construction loan agreement. The increase in possible exposure for construction lenders would also inevitably result in closer scrutiny of loan applications, a higher rejection rate for those applicants deemed to be a higher risk, and a possibly undesirable tightening of the loan market, with a concomitant brake on construction activity.

The Death of the Equitable Lien

In 1967, the California Legislature amended Code of Civil Procedure section 1190.1, adding a new subdivision (n).90 As a result, only two remedies were available to persons who had not been paid for furnishing labor, services, equipment or materials to a construction project. First, such claimants could avail themselves of the stop notice remedy, which required specific procedures, timely service and a sufficient bond. Second, a claimant could pursue a right created by a direct, contractual relationship between the claimant and lender. No other legal or equitable rights could be enforced against the fund.

The legislature apparently had sought to provide relief to construction lenders who, as has been discussed, had heretofore been subjected to increasingly liberal applications of the equitable lien doctrine by California courts. Some commentators91 adopted a "wait and see"

88. Id. at 444-45.
89. Id. at 456.
90. Cal. Stat. 1967, ch. 789, § 1(n), at 2183 (repealed 1969). The statute, which was approved by the governor and filed with the Secretary of State on July 17, 1967, read as follows: "The rights of all persons furnishing labor, services, equipment, or materials for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by this article, and no such person may assert any legal or equitable right with respect to such fund, other than a right created by direct written contract between such person and the person holding the fund, except pursuant to the provisions of this article." The legislative response to the equitable lien appeared to some observers to be inevitable. See, e.g., Burden, supra note 22, at 242.
SECTION 3264 AND EQUITABLE LIENS

position with regard to the impact of the legislature's action. Lefcoe and Schaffer, however, observed that the statutory language might not be the swan song for the equitable lien. In a postscript, they suggested that the language of Code of Civil Procedure section 1190.1 subdivision (n), mandating that the existing rights of claimants were "pursuant to provisions of this article," could be construed as referring to the creation of the preliminary notice—a feature enacted coincidentally in 1967 as an amendment to Code of Civil Procedure section 1193. Such a reading, the authors submitted, would mean that the only change in the application of the equitable lien doctrine would be that it necessarily be preceded by the preliminary notice.

That argument vaporized, however, when the mechanics' lien statutes were recodified and subdivision (n) of former Code of Civil Procedure section 1190.1 emerged in its present form as Civil Code section 3264. After transformation, the statutory language was unequivocal in its expression of the meaning of the prior words "pursuant to the provisions of this article." The new section was amended to specify that claimants' rights to the loan fund "are governed exclusively by Chapters 3 (commencing with Section 3156) and 4 (commencing with Section 3179) of this title." Chapters 3 and 4 of Title 15 deal with the stop notice procedures for private and public works of improvement respectively.

Lefcoe and Schaffer submitted an ingenious argument for the survival of the equitable lien that later worked some confusion on the few courts confronted with Civil Code section 3264 and thereby served

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92. Lefcoe & Schaffer, supra note 4.
93. Id. at 459.
94. Id. at 459 n.4.
96. Cal. Stat. 1969, ch. 1362, § 2780 (codified at CAL. CIV. CODE § 3264 (West 1974)). The new legislation received the approval of the governor on August 31, 1969 and was filed with the Secretary of State on September 2, 1969. However, the operative date of the legislation was specified as January 1, 1971—15 months later. Civil Code § 3264 provides: "The rights of all persons furnishing labor, services, equipment, or materials for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by Chapters 3 (commencing with Section 3156) and 4 (commencing with Section 3179) of this title, and no person may assert any legal or equitable right with respect to such fund, other than a right created by direct written contract between such person and the person holding the fund, except pursuant to the provisions of such chapters."
97. Cal. Stat. 1967, ch. 789, § 1(n), at 2183 (current version at CAL. CIV. CODE § 3264 (West 1974)).
98. CAL. CIV. CODE § 3264 (West 1974).
to perpetuate attempts to make equitable claims upon the loan fund. Addressing former Code of Civil Procedure section 1190.1 subdivision (n), their argument read as follows:

Despite its apparent inclusiveness, a court seeking to impose an equitable lien will find little difficulty working around the statutory imperatives. For instance, the above-quoted section bars equitable liens against "any fund for payment of construction costs." But according to the terms of most construction loans, undisbursed funds are no longer part of the construction fund after default. By the loan terms, the lender retains the right to allocate undisbursed proceeds as it sees fit. Thus the construction fund is converted, if the lender has had his way, into a fund for the repayment of the loan. It is upon this fund ("the construction fund") that courts could impose an equitable lien, notwithstanding the language of the statute.100

The courts first acknowledged the Lefcoe-Schaffer argument in Swinerton & Walberg Co. v. Union Bank.101 Swinerton was a building contractor who contracted with the borrower, Casey, to construct a work of improvement. Union Bank was the construction lender. Casey defaulted on obligations to both the lender and Swinerton, and the latter sought to enforce a lien in equity against unexpended loan funds. Although the loan agreement between the lender and Casey provided that, upon default, the lender could apply undisbursed loan monies against the principal sum due from the borrowers, the bank never applied the excess funds to that purpose and over $100,000 in undisbursed funds remained in the loan account, $74,000 of which was claimed by Swinerton.102

The court held that an equitable lien was a remedy that inured to the benefit of a general contractor as well as any subcontractor. Because the case presented sufficient evidence to establish each requirement necessary for the equitable remedy, Swinerton "became entitled to the $74,000 withheld in the construction loan disbursement account for payment of construction costs."103 Citing Lefcoe and Schaffer, the court stated that it did not read Civil Code section 3264 as indicative of legislative opposition to the imposition of equitable liens against construction loan funds.104

Significantly, however, the court conceded that its interpretation was, on the facts of this particular case, mere dictum. The legislature had specifically provided that former Code of Civil Procedure section

100. Id. at 459 n.4. See text accompanying notes 150-54 infra.
102. Id. at 262, 101 Cal. Rptr. at 666-67.
103. Id. at 265, 101 Cal. Rptr. at 669.
104. Id.
1190.1 subdivision (n) "shall not apply to any work of improvement commenced prior to [8 November 1967]." Because the events in *Swinerton* took place in 1964 and 1965, the court remained free to apply the judicially created remedy of the equitable lien, without statutory interference.

The court in *Boyd & Lovesee Lumber Co. v. Western Pacific Financial Corp.*, decided two and one half years later, did not have this option. In *Boyd*, the court of appeal was for the first time directly confronted with the task of deciding the impact of Civil Code section 3264. This time rather than attempting to assert an equitable lien directly against the loan fund, the plaintiff sought to hold the lender liable for negligently disbursing construction loan funds directly to other subcontractors and materialmen. The plaintiff did not seek recovery under the mechanics' lien or stop notice statutes but, rather, sought recovery in a negligence action.

The lender argued in turn that Civil Code section 3264 precluded recovery on the facts, because the provisions of the statute constituted the exclusive remedy in the absence of a direct written contract between the plaintiff and the lender. No such contractual relationship was alleged and, in light of Civil Code section 3264, the complaint could not have been amended to state a cause of action outside of the statute. The lender prevailed in the trial court and an appeal was taken from a judgment of dismissal following the sustaining of a demurrer without leave to amend.

The court of appeal recognized that a viable action for negligent disbursement required that the lender must have owed some duty of care to the plaintiff to disburse loan funds "in a particular manner, i.e., directly to the plaintiff." Hence, the plaintiff's claims regarding disbursements necessarily amounted to the assertion of a "'right with respect to [the construction loan] fund.' Such falls within the prohibition

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106. *Id.* at 265, 101 Cal. Rptr. at 669.
108. *Id.* at 462, 118 Cal. Rptr. at 699-700.
109. *Id.* at 463, 118 Cal. Rptr. at 700.
110. The court of appeal succinctly disposed of any possible claim based on contract: "Plaintiff does not and apparently cannot allege any 'direct written contract' between itself and respondent [lender]. Hence no recovery can be had on the theory of a contract express or implied." *Id.* The court observed that Civil Code § 3152 recognized actions against persons with whom a claimant had contracted but noted that such contract actions involved rights and liabilities of persons personally responsible on the original contract for labor and materials. *Id.* at 463 n.1, 118 Cal. Rptr. at 700.
111. *Id.* at 463, 118 Cal. Rptr. at 700.
of section 3264."

Viewing the literature, the court observed that most commentators considered the imposition of equitable liens on a construction loan account to be a dead remedy in light of Civil Code section 3264. However, it acknowledged that other writers such as Lefcoe and Schaffer argued that the legislature's enactment of former Code of Civil Procedure section 1190.1 subdivision (n) was intended to abrogate further judicial expansion of the equitable lien doctrine and that, when used to prevent unjust enrichment, the equitable lien might still survive. The court also recognized that only two prior cases had considered the effect of Civil Code section 3264 and its predecessor, Code of Civil Procedure section 1190.1 subdivision (n), since the enactment of the latter section eight years earlier. Swinerton had merely held that the statute did not operate retroactively, and the court of appeal's opinion in Connolly Development v. Superior Court, though noting that "the enactment of section 3264 [Civil Code] abolished any theory of equitable lien," had been vacated on other grounds and granted a hearing by the supreme court. Thus, the Boyd court was essentially writing upon a clean slate when it expressed its conclusions as to the impact of section 3264:

We feel . . . that the death of the equitable lien lends some stability to the construction and lending industries. . . . A fair line is drawn between the contractors, subcontractors, and materialmen on the one hand and the construction lenders on the other. The former at least have remedies by mechanic's lien against the property, unbonded stop notice against the owner, and action upon the contract against the person or persons personally ordering the labor or material. The latter are relieved of the expense and risk of policing the ultimate distribution of construction funds and can concentrate on their primary duty of providing construction loans at lesser expense to the borrower and ultimately to the consuming public. Because of these considerations we hold that section 3264 abolishes all theories of equitable liens or trust funds.

112. Id. at 464, 118 Cal. Rptr. at 700-01.
113. Id.
117. Id. at 465, 118 Cal. Rptr. at 701-02 (emphasis added). The court also observed, in a
Had the court in *Boyd* elected to stand on its firm declaration of the impact of Civil Code section 3264 on the construction lending industry, claimants such as the plaintiff in that case would have simply walked away, wiser with the knowledge that they must avail themselves of the statutory remedies or suffer the loss. Construction lenders could have finally breathed a sigh of relief knowing that if they complied with the statutes they need not defend against the plethora of theories asserted by claimants neglectful of their rights. For reasons that are unclear, however, the court chose to leave a glimmer of hope to those adherents of the Lefcoe and Schaffer position: “Even if the theory of Lefcoe and Schaffer is adopted and equitable liens are allowed to wipe out windfall profits to either lender or borrower, the result in this case is the same. No cause of action is stated. There is no allegation of unjust enrichment.”

Although it seems clear that the court was merely posing a hypothetical to emphasize the hopelessness of plaintiff’s case, such a comment certainly permits a plausible inference that a viable cause of action could be stated under the old equitable lien doctrine in cases where unjust enrichment was alleged. Claimants are quick to point to that flaw in the *Boyd* holding as justification for proposing unjust enrichment as well as other novel theories as supplements to the mechanics’ lien, stop notice, and contract rights. Yet, to draw that conclusion would appear to be in direct contradiction to the court’s unequivocal holding that “section 3264 abolishes all theories of equitable liens.”

Indeed, at least one other court later alluded to the materiality of unjust enrichment when evaluating the effect of Civil Code section 3264 by citing the *Boyd* case. Nonetheless when, after almost two years of deliberation, the California Supreme Court handed down its extensive analysis of the mechanics’ lien and stop notice statutes in *Connolly Development, Inc. v. Superior Court*, its footnote comment on *Boyd* footnote, that materialmen and subcontractors would nonetheless have adequate protection at law to enforce their right of payment. *Id.* at 465 n.2, 118 Cal. Rptr. at 702. *See also* Security Transactions, supra note 42, at 73: “In addition to the judicially created doctrine of equitable liens, the labor or material supplier had three remedies available to him to secure the payment for his labor or services, and the remedies are cumulative. These remedies are: a recorded lien upon the property upon which the labor or materials supplier has bestowed labor or furnished materials, . . . a stop notice served upon the lender or other holder of the construction fund . . . or a suit in contract against the owner or general contractor.”

footnote

118. 44 Cal. App. 3d at 466, 118 Cal. Rptr. at 702.
119. *Id.* at 465, 118 Cal. Rptr. at 702 (emphasis added).
and the effect of section 3264 was concise and unequivocal:

Under the theory of equitable lien, the courts held that a person who was induced to supply labor and materials in reliance upon the construction loan fund could assert a lien against that fund. (See *A-I Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass’n.* . . . ; *Smith v. Anglo-California Trust Co.* . . . ) The enactment of Civil Code section 3264 in 1969 abolished the nonstatutory equitable lien. (*Boyd & Lovesee Lumber Co. v. Western Pacific Financial Corp.* . . . )

The supreme court’s comment in *Connolly* is the last published judicial interpretation of Civil Code Section 3264.

**The Proper Scope of Civil Code Section 3264**

The paucity of judicial treatment of Section 3264 has not permitted full explication of the underlying holdings of *Boyd* and *Connolly* with regard to the numerous other legal and equitable rights often asserted by claimants. A comprehensive treatment of the statute requires, therefore, discussion of both its specific provisions and their proper and probable application to these theories.

Subdivision (n) of former Code of Civil Procedure section 1190.1 was specifically added to that section in 1967 and when it was later recodified as Civil Code section 3264 in 1969, the change in statutory language was minimal. As has already been noted, the original statute referred to claimant’s rights being governed by “this article” meaning then Article 2, Chapter 2, of Title 4. Civil Code section 3264 clarified the fact that “this article” referred to the stop notice remedy by specifying the statutes by section: “Chapters 3 (commencing with Section 3156) and 4 (commencing with Section 3179).” Otherwise, the statutory language remained intact.

The language of Civil Code section 3264 is characterized by both highly inclusive language and lack of equivocation. The class of persons to which the statute applies is stated to be “all persons furnishing labor, services, equipment, or materials for any work of improvement.” Thus, by its terms the statute applies to laborers, materialmen, subcontractors, and even the general contractor. The significance of this last category of claimant is that the general contractor does not qualify as a person who is entitled to the stop notice remedy.

122. *Id.* at 827 n.23, 553 P.2d at 653, 132 Cal. Rptr. at 493 (citations omitted).
123. See text accompanying notes 95-98 *supra.*
124. See note 98 & accompanying text *supra.*
126. *Id.* (emphasis added).
127. *CAL. CIV. CODE* §§ 3158-3159 specify that the original contractor, see note 5 *supra,*
Moreover, Civil Code section 3264 applies to such persons who participate in *any* work of improvement, whether a single family dwelling or a massive construction project. Similarly, "work of improvement," as defined by Civil Code Section 3106128 is itself a broad category of activity, including items ranging from alteration or repair of virtually any structure in whole or in part to activities such as seeding and planting of shrubs.

The main qualifier of Civil Code section 3264 with regard to such persons and activity is, however, that it is applicable to the rights of such persons "with respect to any fund for payment of construction costs." For the statute to apply, the claimant must be asserting a right to payment from a fund designated as the source of payment for the costs of constructing the work of improvement. The statute should not, however, be read as addressed only to the narrow situation of the claimant who specifically seeks imposition of an equitable lien. The phrase "with respect to" does not mean simply a direct attack on the loan fund itself. The language is broader in scope and appears to address indirect attacks as well. The basic test, so far as one may be discerned, appears to be whether the rights asserted focus on activities of the construction lender undertaken with regard to the loan fund. In other words, but for the lender’s action vis-a-vis the loan account, the cause of action could not be alleged. If such is the case, Civil Code section 3264 applies to preclude recovery.

Claimants frequently attempt to circumvent the statute by setting forth actions asserted as not being actions “with respect to such fund.” A plaintiff may argue that his is an independent tort action for the lender’s negligence in disbursing or concealing loan monies and not an action against the fund itself. But, as was noted in *Boyd*, negligence can only arise if there exists some duty of care owed to the claimant

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128. See note 1 supra.
129. CAL. CIV. CODE § 3264 (West 1974).
from the lender. The only duty shown within the context of the Boyd case was one relating to the disbursement of loan funds in a particular manner and, hence, recovery for negligence must be based on the assertion of a "right with respect to such fund." The court in affirming the lower court's decision noted that section 3264 applies to preclude recovery on the basis of any such alleged negligence of the lender with regard to the fund.

Concealment of loan funds is another frequent cause of action asserted. Application of the basic test reveals that the only duty which could be breached would be a duty to disclose to the claimant the lender's activities with regard to the construction loan fund. If such a duty to disclose disbursement of loan funds existed and inured to all claimants, the practical effect would be overwhelming. Finding such a general duty would also ignore the Boyd court's distinction between the respective roles of contractor, subcontractor, and materialman on the one hand and the construction lender on the other. Most importantly, a cause of action for concealment could only be alleged with regard to the lender's activity as to the loan fund and must necessarily be the assertion of a right with respect to such fund. It would therefore fall within the ambit of and be barred by section 3264. The same basic reasoning should preclude other legal and equitable rights asserted to the fund, such as negligent entrustment, constructive trust, and unjust enrichment.

Section 3264, of course, does not give the lender license to engage with impunity in tortious conduct. In an earlier Article, this author has pointed out that statutes precluding actions against a construction lender must be limited to those situations specifically addressed by the

131. Id. at 464, 118 Cal. Rptr. at 701.
132. 12 BIEL & SENEKER, supra note 8, § 420.91[6]; 13 BIEL & SENEKER, supra note 8, § 452.03.
134. For example, some larger construction projects require the participation of hundreds of laborers, materialmen and subcontractors. If the construction lender were required to apprise each potential claimant of loan funds of the current status of the loan account, the result would be an administrative nightmare. Generally, however, the mere entry into a construction loan agreement, without more, does not create in either the general contractor or any subcontractor or materialman the status of a third party beneficiary in a position to be entitled to such information. See Gordon Bldg. Corp. v. Gibraltar Sav. & Loan Ass'n, 247 Cal. App. 2d 1, 9-10, 55 Cal. Rptr. 884, 888-89 (1966); Smith v. Anglo-California Trust Co., 205 Cal. 496, 502, 271 P. 898, 901 (1928); see note 141 & accompanying text infra.
135. See note 117 & accompanying text supra.
Obligations and duties of the lender that arise independent of its role as lender are still enforceable. For example, if the construction lender perpetrated actual fraud upon the claimant by representing that a claim would be paid without the necessity of serving a stop notice, the lender could not then seek shelter behind section 3264 if the claimant, in reliance thereon, did not in fact serve the lender with a stop notice. The fraud action would be independent of the lender's role as a lender and the cause of action would not be barred.

Another possible separate cause of action, not turning on the lender's management of the loan account, is recognized in the language of the statute itself. Section 3264 provides that, other than the stop notice, no legal or equitable right may be asserted with respect to such fund "other than a right created by direct written contract between [the claimant] and the person holding the fund." That separate contractual remedy does not depend on the lender's management of loan funds or, indeed, its role as a lender to the project. It is based upon and supported by its own facts, the existence of the contract, just as the earlier discussed fraud action.

However, the written contract exception to Civil Code section 3264 has given rise to its own special problems. The section specifies that the only exception to its applicability is the existence of a "direct written contract" between the claimant and the lender. Normally, when a statute carves out a specific exception to its applicability it is assumed that no other exceptions were intended by implication or otherwise. With that concept in mind, a question arises as to the purpose and meaning of the modifier "direct."

"Direct" has been defined as "operating by immediate connection or relation . . . [w]ithout any intervening medium, agency or influence." Indeed, the legislature's use of the word "direct" precedent to

137. CAL. CIV. CODE § 3264 (West 1974).
138. Id.
139. Under the maxim of Expressio Unius Est Exclusio Alterius, if a statute specifies one exception to a general rule or assumes to specify the effects of a certain provision, other exceptions or effects are excluded. BLACK'S LAW DICTIONARY 692 (4th rev. ed. 1968). See generally 45 CAL. JUR. 2d Statutes § 133 (1958). Too, the rules of statutory construction are such that the intent behind the legislature's action is determined from the language of the statute read as a whole, and, if the words used are reasonably free of uncertainty, the court will look no further than the statute itself to ascertain its meaning. Rosenthal v. Hansen, 34 Cal. App. 3d 754, 760, 110 Cal. Rptr. 257, 261 (1973).
"written contract" clearly implies an intention to preclude assertion of the requisite relationship by way of a circuitous route: claiming to be a third party beneficiary to a contract, or alleging the existence of an agency, for example. The exception to the mandate of section 3264, therefore, is simply that, other than the stop notice remedy, a claimant to the construction loan fund may only assert a right based upon a contractual relationship which (1) is a writing sufficient to satisfy the Statute of Frauds, and (2) is a contract directly between the claimant and the lender regarding payments to the claimant from the loan fund.

In sum, the restrictive effect of section 3264 provides needed stability to the construction lending industry. Section 3264 contemplates a claimant’s knowledge of the remedies available to protect his rights; failure to avail itself of those rights can no longer be cured by alleging alternative legal or equitable theories to attack the loan fund. The leading remedy available to laborers and materialmen in addition to the mechanics' lien or contract remedies is the stop notice. The stop notice is an extraordinary remedy and effects an equitable garnishment on the fund. If accompanied by a sufficient bond, the

141. For a person to assert the status of a third party beneficiary that person must have been expressly understood and intended to be the beneficiary of the contract. "Expressly," for the purposes of determining that status means "in an express manner; in direct or unmistakable terms; explicitly; definitely; directly." Shepard v. Miles & Sons, Inc., 10 Cal. App. 3d 7, 15, 89 Cal. Rptr. 23, 28 (1970). In Gordon Bldg. Corp. v. Gibraltar Sav. & Loan Ass'n, 247 Cal. App. 2d 1, 9, 55 Cal. Rptr. 884, 888 (1966), the court, in denying third party beneficiary status to a general contractor, commented: "A contract made solely for the benefit of the contracting parties cannot be enforced by a stranger or one who stands to benefit merely incidentally by its performance."


143. But cf. Benson Elec. Co. v. Hale Bros. Assocs., 246 Cal. App. 2d 686, 55 Cal. Rptr. 73 (1966) and Halspar, Inc. v. La Barthe, 238 Cal. App. 2d 897, 48 Cal. Rptr. 293 (1965) where, in interpreting former CAL. CODE CIV. PROC. § 1193(a) (West 1954) (current version at CAL. CIV. CODE § 3097 (West 1974)), the courts held that the statute was satisfied if a lien claimant contracted directly with the lessee of property and if the lessor knew of the construction under the contract but failed to file a notice of nonresponsibility. See CAL. CIV. CODE §§ 3094, 3129 (West 1974). The courts held that in such cases the claimant had a "direct contract with the owner" for the purposes of the statute. Application of those holdings to the construction lender and the claimant may be inappropriate in that the owner's knowledge of construction on his property and the lender's knowledge of a claim to construction loan funds are not analogous situations.

144. MARSH, supra note 2, § 5.27.

145. See Gutierrez, supra note 136, at 12 n.69. But see Lefcoe & Schaffer, supra note 4, at 441.

lender has no choice but to withhold funds from the balance of the loan account adequate to meet the stop notice claim. It is cumulative and can be pursued even if it is not the only remedy asserted.\textsuperscript{147} If all the prerequisites are met, a stop notice claim creates a lien on the entire fund remaining in the lender's possession and not merely the installment due when the stop notice is received.\textsuperscript{148} An actual problem may arise, however, when the stop notice is received and no funds remain in the loan account, leaving no funds to be garnished by the stop notice. The stop notice remedy in such a circumstance affords the claimant no protection. If, however, construction funds remain, the lender may not apply those funds to the balance due on the loan in disregard of a properly served bonded stop notice. Failure of a claimant to comply fully with the stop notice procedure will otherwise permit the lender to set off undistributed loan funds against the debt of the borrower in accordance with the typical construction loan agreement.\textsuperscript{149}

As noted earlier, Lefcoe and Schaffer suggested that an equitable lien might still exist in the latter situation against the unexpended loan proceeds.\textsuperscript{150} They reasoned that upon the borrower's default the loan fund was transmuted into a fund other than one for payment of construction costs. Because a construction loan agreement might provide for the use of the funds by the lender in ways other than construction, such as against principal and overdue interest, the authors took the position that the fund was lifted out of the mandate of the statute and, hence, subject to an equitable lien to prevent an unjust enrichment.\textsuperscript{151} This argument ignores the fact, however, that unexpended loan funds may be applied to the completion of an unfinished construction project.\textsuperscript{152} Regardless of the manner in which the funds are applied, what appears to this author to be the essential issue is the purpose for which the construction loan account was originally established and not how it might later be characterized after default. But for the creation of the construction-costs loan account the claimant would not be entitled to any money from the holder of the fund.\textsuperscript{153} Thus, a fund created at the

\textsuperscript{147. 13 BIEL \& SENEKER, supra note 8, § 452.02.}
\textsuperscript{148. Idaco Lumber Co. v. Northwestern Sav. \& Loan Ass'n, 265 Cal. App. 2d 490, 497, 71 Cal. Rptr. 422, 427 (1968).}
\textsuperscript{149. CONTINUING EDUCATION OF THE BAR, CALIFORNIA MECHANICS' LIENS \& OTHER REMEDIES § 8.32 (1972).}
\textsuperscript{150. See Lefcoe \& Schaffer, supra note 4, at 459 n.4.}
\textsuperscript{151. Id.}
\textsuperscript{152. CONTINUING EDUCATION OF THE BAR, CALIFORNIA MECHANICS' LIENS \& OTHER REMEDIES § 8.33 (1972).}
outset for payment of construction costs maintains its character as long as monies exist. That the assertion of a claim with respect to such a fund should fall within the prohibition of section 3264 would seem to be true regardless of the stage of the construction project, including upon and after default by the borrower.154

There is, of course, logical appeal on behalf of lien claimants who in some cases will not receive payment for their labor and materials supplied to a construction project. Such persons have to some varying degree enhanced the construction lender's security interest. Likewise, the persuasiveness and attractiveness of making the lender an insurer of payments to lien claimants is, as Justice Sims commented in *McBain*,155 easy to recognize. The frustrating effect of permitting the lender to retain unexpended loan funds possibly in excess of the amount required to repay the principal debt, interest and costs, while some laborers and materialmen go unpaid, is obvious. Much of the so-called unjust-enrichment argument does not, however, recognize the lender's actual function with regard to the construction project.

The construction loan is normally secured by a first deed of trust on the real property in its unimproved state. All labor and materials supplied to the project after construction begins, to some degree, enhances the lender's security. If construction stops with the improvement unfinished, the lender must be able to take steps to preserve its right to repayment of the debt amount plus interest, as well as any costs incurred through foreclosure and, if appropriate, completion of the project.156 The limited role of the lender in construction enterprise is often blurred in the the eyes of others by contemplation of the extraordinary amounts of money that most institutional lenders deal in.157 Consequently, it has been suggested that construction lenders are

154. Cf. Lefcoe & Schaffer, supra note 4, at 444: "[T]he term 'unjust enrichment' is usually reserved for the case in which a man receives something for nothing, not for the situation in which he innocently pays someone (other than his agent) who then absconds. Strictly speaking, a lender could not be said to have been unjustly enriched as long as he had extended funds to the borrower for the full value of the project at the date of default. If lenders are to be compelled to pay a second time, it must be on another theory."


156. Continuing Education of the Bar, California Mechanics' Liens & Other Remedies § 8.32 (1972).

157. When claims against lenders are allowed on nonstatutory grounds, commentators argue that the courts have utilized a risk spreading device of the type characterizing the law of strict products liability. See, e.g., Lefcoe & Schaffer, supra note 4, at 458: "[C]onstruction lenders typically have deeper pockets than materialmen, and are in a better position to distribute these losses in smaller chunks to shareholders, depositors, and borrowers." See also Gutierrez, supra note 136, at 13 n.75.
in a position to actively participate in the construction project beyond their primary function of loaning money at interest on the security of real property.\textsuperscript{158} The flaw in this argument is that placing additional obligations on construction lenders, such as to ensure that claimants are paid or that the work performed is not defective, may have the result of exposing lenders to unexpected liability for the entire construction effort.\textsuperscript{159} The foreseeable and unfortunate consequences of placing unbargained-for risk on the lender are higher rates of interest, more restrictive loan policies, and the inevitable squeezing-out of smaller developers. For this reason one recent decision\textsuperscript{160} has refused to recognize any "modern trend" of law dictating the creation of duties and obligations of the lender beyond its normal function as lender of money.\textsuperscript{161}

\section*{Conclusion}

Claimants seeking to enforce an entitlement to loan funds through means other than the bonded stop notice or a direct written contract with the lender must confront the language of Civil Code Section 3264. The statute as currently written provides that a lender performing its function as a lender of money in accordance with law should be entitled to the benefit of its bargain and not be subjected to collateral attacks on its security.\textsuperscript{162} Likewise, if claimants make prudent use of the statutes that afford them protection they will receive payment\textsuperscript{163} for their labor or materials by way of a known and powerful remedy\textsuperscript{164}—the bonded stop notice. If there are undisbursed funds in the construction loan account, the claimant's recovery, in whole or in part,\textsuperscript{165} is assured; if not, all participants lose. Section 3264 provides that a lender will not have to meet and defend against the varied claims of each laborer or materialman who did not use the remedies provided for his protection. Indeed, construction lenders may not be aware of the existence of every laborer or materialman who contributes to the

\textsuperscript{158} See Lefcoe & Schaffer, supra note 4, at 442.
\textsuperscript{159} Gutierrez, supra note 136, at 22-24.
\textsuperscript{160} Kinner v. World Sav. & Loan Ass'n, 57 Cal. App. 3d 724, 129 Cal. Rptr. 400 (1976).
\textsuperscript{161} Id. at 730, 129 Cal. Rptr. at 403.
\textsuperscript{162} See also CAL. CIV. CODE § 3434 (West 1970).
\textsuperscript{163} Stop notice claimants share on a pro rata basis in unexpended loan funds. CAL. CIV. CODE § 3167 (West 1974); Hunt, The Stop Notice Remedy in California, 37 L.A.B. BULL. 16, 19 (1962).
\textsuperscript{164} Miller, Validity of the Stop Notice As a Summary Remedy, 48 CAL. ST. B.J. 44 (1973).
\textsuperscript{165} CAL. CIV. CODE § 3167 (West 1974).
construction project or may not know, without the receipt of a stop notice, who claims entitlement to construction loan funds.\textsuperscript{166} To force a lender, through artful pleading, to compromise or defend against legal or equitable claims specifically precluded by section 3264 is to defeat the statute's purpose. The policy behind affording lenders the protection of section 3264 was concisely articulated in \textit{Boyd}:

\textit{[The death of the equitable lien . . . [relieves construction lenders] of the expense and risk of policing the ultimate distribution of construction funds and [they] can concentrate on their primary duty of providing construction loans at lesser expense to the borrower and ultimately to the consuming public.}\textsuperscript{167}

If the result is to leave some claimants unpaid while a lender receives unexpended loan funds over and above that provided for in its contract with the borrower, then legislative action may be necessary to balance the equities. However, courts must deal with the statutes as they presently exist. In addressing a cause of action that falls within the basic test of the applicability of Civil Code section 3264, they must yield to the statutory mandate which prevents the assertion of other legal or equitable rights to the loan fund regardless of the sufficiency of the cause of action as a pleading.
