MILLER & STARR
REAL ESTATE NEWSALERT

Reprinted in part from
Volume 24, Number 5, May 2014
(Article starting on page 407 in the actual issue)

ARTICLE

CONSTRUCTION LENDERS BEWARE: UNBONDED STOP-PAYMENT NOTICES MAY BE WORTH MORE THAN THE PAPER THEY ARE WRITTEN ON

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I. INTRODUCTION

A common perception in the construction industry is that the most valuable part of an unbonded stop payment notice[1] is the paper it is written on, at least when it is served on a construction lender. While an unbonded stop payment notice may be effective against the project owner holding construction funds, it is understood to be ineffective against a construction lender. This understanding stems from the language of the stop payment notice statute, which provides that a construction lender may, but is not obligated to, withhold construction loan funds if it is served with an unbonded stop payment notice. Stop payment notice claimants construe the optional nature of a construction lender's withholding obligation as a rule of law barring enforcement of unbonded stop payment notices.

However, the notion that an unbonded stop payment notice is unenforceable against a construction lender appears to conflate the obligation to withhold construction loan funds in response to a stop payment notice and its enforceability. The language of Civil Code, §8536, subd. (b)(1) (and its predecessor, Civil Code, §3162) only provides that a construction lender may refuse to *withhold* construction loan funds in response to a stop payment notice; it does not provide that an unbonded stop payment notice is, per se, unenforceable to the extent construction loan funds remain undisbursed or otherwise available following service of a stop payment notice.

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This article explores whether it may be possible to construe the stop payment notice statutes as sanctioning enforcement of an unbonded stop payment notice to the extent construction loan funds remain undisbursed to the borrower. It further explores the potential to enforce an unbonded stop payment notice against the portions of a construction loan not disbursed directly to the borrower to pay for hard costs of construction, commonly referred to as "*Familian* funds,"[2] such as "interest reserve" funds allocated for payment of a borrower's obligation to pay interest on the loan.

II. BACKGROUND AND PURPOSE OF STOP PAYMENT NOTICES

A stop payment notice is the rough equivalent of a mechanics lien, but instead of attaching to real property, it attaches to a construction loan fund.[3] A mechanics lien is a direct lien against the real property to which the claimant is contributing work, labor, or materials.[4] Mechanics lien priority, with only limited exceptions, relates back to the date work first started on the improvement under construction.[5] Thus, if work commences before a construction loan deed of trust is recorded (or before claimant had actual notice of the deed of trust), the mechanics lien is senior to the deed of trust.[6] Conversely, if the construction loan deed of trust is recorded before work commenced (or if unrecorded, there is actual notice of the construction deed of trust), the mechanics lien (with limited exceptions)[7] would be junior to the deed of trust.[8]

Due to the relatively bright-line mechanics lien priority rule, a diligent construction lender can effectively insulate itself from mechanics lien liability by ensuring that its construction loan deed of trust records before work commences. Where a construction lender has taken appropriate steps to ensure the priority of its construction loan deed of trust and where there is no equity in the property, either due to an economic downturn or the fact that the outstanding balance of the construction loan exceeds the value of the property, claimants can find themselves without any viable mechanics lien remedy. The construction lender's foreclosure will terminate the junior mechanics lien.[9] Without a stop payment notice, the claimant's only remedy would be to sue those it contracted with. Of course, as many contractors discovered during the end of the last decade, developer and contractor insolvencies often render contractual remedies worthless.

Likely due to the inherent imperfection in the mechanics lien remedy, the Legislature created the stop payment notice as an "additional and cumulative remedy."[10] Stop payment notice claims remain viable even when the mechanics lien remedy is rendered valueless due to the priority position of the construction loan deed of trust.[11]

As a lien that attaches to a construction loan fund, and not to land, a stop payment notice is therefore unaffected by the foreclosure of a senior deed of trust.[12] The lien of a stop payment notice on the construction loan fund is superior to the borrower's right to assign the construction loan fund to any third party, irrespective of whether the assignment was made before or after service of the stop payment notice.[13]

Priority of a stop payment notice is unaffected by the date work commenced. A stop payment notice will attach to a construction loan fund, and achieve a senior

position over other competing (non-stop payment notice) claims to the fund, without regard to whether the construction loan was issued before or after work commenced on the project[14] and is unaffected by any private arrangement between a borrower and its construction lender allocating the use, or dictating the disbursement, of the construction loan fund.[15] Even where the borrower has defaulted on the loan, and the construction lender is not obligated under the terms of its construction loan agreement to disburse money to the borrower, the stop payment notice claim will be unaffected by this contractual arrangement and will still attach to the loan fund.[16] In other words, neither a borrower nor a construction lender may insulate construction loan funds from the reach of a stop payment notice through any type of contractual arrangement. The only way to exempt construction loan funds from the stop payment notice claims is to disburse those funds to the borrower to use to construct the improvement.

III. STOP PAYMENT NOTICE PERFECTION AND ENFORCEMENT PROCEDURES

Pursuing stop payment notice claims involves two basic steps: perfection and enforcement. Perfection is accomplished by "giving" the stop payment notice document prepared in the correct statutory form to the project owner and construction lender. Enforcement is accomplished by timely filing a complaint stating a valid cause of action for enforcement of a stop payment notice.

In general, any person with a statutory right to record a mechanics lien may also give a stop payment notice to a project owner and construction lender.[17] Parties entitled to record a mechanics lien, and by extension to give a stop payment notice, include direct contractors, subcontractors, material suppliers, equipment lessors, laborers, and design professionals.[18] The requirements and procedures for serving a stop payment notice are prescribed by separate statutes applicable to public and private works.

A stop payment notice may be enforced against the project owner, the construction lender,[19] or both, except that a direct contractor may not enforce a stop payment notice against the project owner with whom the contractor directly contracted.[20]

A construction lender must react to a stop payment notice that is accompanied by a bond in the amount of 125% of the claim by withholding construction loan funds from the project owner in an amount sufficient to pay the claim stated in the notice.[21] A construction lender may elect *not* to withhold construction loan funds where a stop payment notice is not bonded.[22] In other words, when faced with an unbonded stop payment notice, the lender may disregard the notice[23] and continue to disburse loan funds to the project owner. However, a construction lender who fails to withhold sufficient funds to satisfy a bonded stop payment notice claim may become personally liable to the claimant even though the lender is not in privity of contract with the claimant.[24]

A claimant enforces a stop payment notice claim by filing a complaint stating a valid cause of action for enforcement of the stop payment notice. A stop payment notice enforcement action may be commenced beginning ten days from the date the claimant first gave the stop payment notice until 90 days after expiration of the

time to give the stop payment notice. A prematurely-filed stop payment notice action will be barred as untimely.[25] However, a claimant who filed a stop payment notice action prematurely may cure its error by dismissing (without prejudice) the early-filed action and later filing a timely action. Dismissal without prejudice does not invalidate the stop payment notice.[26] In addition, a stop payment notice does not expire, so long as the claimant timely files its enforcement action.

Where multiple claimants have filed stop payment notice enforcement actions, withheld funds must be disbursed first to claimants who have given bonded stop payment notices[27] and next to claimants who have given unbonded stop payment notices, if any funds are remaining after the first disbursement tranche.[28] If withheld funds are not sufficient to pay all claims in a particular tranche, the funds must be disbursed among the claimants within the tranche in question on a pro rata basis.[29] Claims will be paid irrespective of the order in which the stop payment notices were given or the enforcement actions filed. Further, in the case of a bonded stop payment notice, a prevailing claimant may recover interest at the legal rate calculated from the date the stop payment notice was given[30] and the prevailing party (whether the claimant or the fund holder) may recover its reasonable attorney's fees.[31] However, no statute provides for interest or attorney's fees in an action to enforce an unbonded stop payment notice.

IV. EXISTING CASE LAW SUGGESTING UNENFORCEABILITY OF AN UNBONDED STOP PAYMENT NOTICE IS FAR FROM DISPOSITIVE

Even though the statutes seem to allow for the possible enforcement of unbonded stop payment notice claims against a construction lender, two court decisions appear to support a contrary result. One is a California Supreme Court opinion[32] stating a construction lender may "disregard" an unbonded stop payment notice. The other is an aged Court of Appeal opinion[33] based on the language of an earlier stop payment notice statute that holds a claimant may not enforce an unbonded stop payment notice against a construction lender where the construction lender exercised a borrower's assignment of construction loan funds and disbursed the remaining balance of a construction loan to itself following the borrower's loan default. On reflection, however, neither of these decisions support the perception in the construction industry that an unbonded stop payment notice may not be enforced against a construction lender.

In *Connolly Development, Inc. v. Superior Court* ("*Connolly*"), the California Supreme Court determined that the mechanics lien and stop payment notice statutes complied with constitutional due process requirements. Part of the Court's opinion summarized the law of stop payment notices. In that section of the opinion, the Court stated that a construction lender may "disregard" an unbonded stop payment notice.[34] Many claimants have taken this to mean that an unbonded stop payment notice is unenforceable. However, the Court's statement that a construction lender may disregard an unbonded stop payment notice means only that the lender may decide to not withhold funds and instead continue to disburse them to the borrower. That the Court meant "refuse to withhold" when it said "disregard' is made clear by

the Court's very next statement: "but upon receipt of a notice accompanied by a bond equal to one and one-fourth times the amount of the claims (§3083) the lender must withhold from the unexpended balance of the loan fund a sum sufficient to pay the claim."[35] Nowhere did the Court state that an unbonded stop payment notice is unenforceable. Therefore, *Connolly* is not authority for the proposition that an unbonded stop payment notice may not be enforced.

In *Miller v. Mountainview Savings & Loan Association* ("*Miller*"), a construction lender and project developer entered into a building loan agreement to finance the construction of five residential structures on five separate lots. The building loan agreement provided that the construction loan proceeds were to be deposited with and assigned to the construction lender as security for its loan and disbursed to the borrower/developer as construction proceeded. Interest was due on only the funds actually disbursed for the first 90 days after loan closing. Starting with the 91st day, interest became payable on the entire loan amount retroactively to the closing date. The construction lender reserved the right to credit undisbursed funds against the debt in the event the borrower defaulted.

Thus, the entire construction loan amount was treated as outstanding on the day the construction loan closed. If the borrower defaulted after one-half of the construction loan was disbursed, and the construction lender accelerated the debt, the borrower would owe the construction lender 100% of the loan amount, despite the fact only 50% was disbursed. However, the construction lender could credit-back the undisbursed funds to itself and thereby reduce the outstanding debt to 50% of the loan amount.

The borrower/developer defaulted under the building loan agreement partway through construction and also failed to pay a plumbing contractor for its work. The construction lender then exercised its security interest in the unexpended construction loan funds and credited the undisbursed portion of the construction loan fund against the borrower's outstanding debt.

The contractor filed a complaint to foreclose on its mechanics lien, to enforce an unbonded stop payment notice, and to impose an equitable lien on the construction loan fund.[36] The contractor's mechanics lien remedy was terminated by the construction lender's foreclosure of its senior deed of trust and the contractor was left with its unbonded stop payment notice and equitable lien remedies.

The trial court ultimately ruled that the contractor was entitled to an equitable lien on the construction loan fund that precluded the construction lender from "crediting back" the undisbursed construction loan monies in disregard of the contractor's claim. Although it was not entirely clear from the opinion, it appears the trial court refused to enforce the contractor's unbonded stop payment notice.

On appeal, the construction lender challenged the trial court's imposition of an equitable lien against the undisbursed construction loan funds and argued that even if the unbonded stop payment notice were valid, there were no construction loan funds remaining to which the stop payment notice could attach because the stop payment notice was received after the construction lender had applied the undisbursed construction loan balance against the outstanding debt. The contractor

countered that the construction lender's credit-back amounted to an assignment of construction loan funds in violation of the stop payment notice statute in effect at that time and could not serve as a basis to avoid the contractor's unbonded stop payment notice claim. Therefore, the unbonded stop payment notice created a lien against the portion of the construction loan fund that had not been disbursed to the borrower/developer.

The court of appeal acknowledged the anti-assignment provisions of the stop payment notice statutes, but held that the prohibition against assignment applied only where a claimant had served a bonded stop payment notice. Therefore, the contractor's unbonded stop payment notice was ineffective because there were no construction loan funds remaining after the construction lender's exercise of its assignment. In other words, the court of appeal applied the anti-assignment statute[37] differently as between bonded and unbonded stop payment notices. The court of appeal determined that while an assignment of pre-allocated construction loan funds could not avoid the reach of a bonded stop payment notice, if given an unbonded stop payment notice, the construction lender was free to place the construction loan funds out of reach of the claimant by assigning them to itself or others. The court of appeal's decision in *Miller* effectively negated unbonded stop payment notices by permitting a construction lender to avoid their reach by taking an assignment of any construction loan funds not previously disbursed to the borrower and exercising that assignment and paying-over the undisbursed funds to itself following a borrower's default.[38]

The *Miller* court's reasoning focused heavily on the point that a construction lender can refuse to withhold construction loan funds in response to an unbonded stop payment notice. The court appears to have morphed the concept that a construction lender may continue to disburse construction loan funds to a borrower upon receipt of an unbonded stop payment notice into permission to ignore the anti-assignment provision of the stop payment notice statutes. The court of appeal stated:

> Under the statute, in the absence of a bond, there would be no duty to withhold from the owner under such circumstances. If there is no obligation to withhold, the fund holder as lender should not be precluded from reducing, rather than increasing, the amount of indebtedness which the owner or any lien holder coming under him, including respondent [the contractor], would have to pay to relieve the default after notice of breach and election to sell.[39]

Miller did not hold that unbonded stop payment notices are unenforceable, only that a construction lender may avoid the reach of an unbonded stop payment notice by exercising an assignment of a portion of a loan fund and disbursing that portion to itself. The court reasoned that because a construction lender may refuse to withhold construction loan funds, and continue to disburse them to the borrower, it may likewise exercise an assignment of construction loan funds upon a borrower's default, pay itself any outstanding loan balance, and thereby avoid an unbonded stop payment notice.

This holding may have been supported by the stop payment notice statutes in existence at the time of the opinion, but the current iteration of the stop payment

notice statutes appear to dictate a different result. The operative statute governing the ability to assign a construction loan fund in effect at the time of the *Miller* decision was Code of Civil Procedure §1190.1, subd. (h), the second paragraph of which provided:

> If [a stop payment notice claimant] entitled to file [a stop payment notice] under this subsection files with the person holding such funds as a fund from which to pay such construction costs, a bond with good and sufficient sureties in a penal sum equal to one and one-quarter times the amount of such claim, undertaking that if the defendant recovers judgment in an action brought on said verified claim or on the lien filed by the claimant, the lien claimant will pay all costs that may be awarded against the owner, contractor, or person holding such funds, or any of them, and all damages that such owner, contractor or person holding such funds may sustain by reason of the equitable garnishment affected by the claim or by reason of the lien, not exceeding the sum specified in the undertaking, then the person holding such funds must withhold from the borrower or other person to whom said owner may be obligated to make payments or advancements out of such fund sufficient money to answer such claim, and any lien that may be filed therefore. No assignment by the owner or contractor of construction loan funds, whether made before a verified claim is filed or after such claim is filed shall be held to take priority over claims filed under this subsection (h) and such assignment shall have no binding force insofar as the rights of claimants to file claims hereunder are concerned.

The aforementioned paragraph could be construed to have tied the prohibition against assignment of the construction loan fund to the requirement that a stop payment notice be bonded. This paragraph addressed both the requirement of a construction lender to withhold construction loan funds when a bond was filed as well as the prohibition against assignment. The effect of including both concepts in the same paragraph is to make it appear as if the prohibition against assignment of construction loan funds was operative only where a stop payment notice was bonded.

In contrast, current Civil Code, §8544 provides: "The rights of a claimant who gives a construction lender a stop payment notice are not affected by an assignment of the construction loan funds made by the owner or direct contractor, and the stop payment notice has priority over the assignment, whether the assignment is made before or after the stop payment notice is given." By its express terms, the current statute does not limit the application of the anti-assignment provision to only situations where the claimant has given a bonded stop payment notice.[40] The statute generically references a "stop payment notice" without specifically calling out a bonded stop payment notice. This general reference strongly indicates that a construction lender may not avoid an action to enforce an unbonded stop payment notice simply by exercising an assignment clause in a construction loan agreement and disbursing to itself any outstanding loan balance. Civil Code, §8044, subd. (a)(3) provides that unless a statute specifically distinguishes between a bonded and an unbonded stop payment notice, the reference to a stop payment notice, generally,

includes both a bonded and an unbonded notice. Therefore, the use of the all-encompassing term "stop payment notice," instead of the specific term "bonded stop notice," in Civil Code, §8544 seems to establish that a construction lender may not avoid an unbonded stop payment notice by exercising an assignment of construction loan funds, as the lender in *Miller* did.

Further, changes in construction lending practices may have effectively obviated the holding in *Miller*. In *Miller*, the construction loan was treated as outstanding as of the loan closing. The entire amount of the loan was placed into a separate account held and controlled by the construction lender. Interest on the entire loan amount was due at closing, but deferred for 90 days (during the initial 90-day deferral period, the borrower was required to pay interest on only loan funds actually disbursed to the borrower from the separate account; thereafter interest was due on the entire loan balance retroactive to closing). Upon the borrower's default, the entire loan debt was due and owing, not just the amount disbursed from the separate account.

Modern construction lending procedures typically do not create separate accounts for the deposit loan funds. Instead, construction lenders hold the funds and disburse them to borrowers in conjunction with monthly draw requests. The loan debt equals only the amount disbursed, not the entire balance of the commitment. Therefore, applying the basic facts of *Miller* to modern construction lending practices may lead to a different result. Upon the borrower's default, the construction lender would cease all disbursements, essentially withholding from the borrower the undisbursed loan balance. That withheld amount would be subject to a claimant's unbonded stop payment notice claim. In *Miller*, there were no "withheld" loan funds, since the court treated the entire loan balance as due and owing upon deposit into the separate account. Under modern construction lending practice, only the amount actually disbursed from the construction lender's funds would be due and owing and, therefore, the remaining balance of the original commitment would likely be treated as withheld funds subject to an unbonded stop payment notice claim.

V. THE POTENTIAL FOR ENFORCEMENT OF AN UNBONDED STOP PAYMENT NOTICE AGAINST A CONSTRUCTION LENDER UNDER CURRENT STATUTES

Current stop payment notice statutes are clear that an unbonded stop payment notice may be enforced against a project owner. It is equally clear that a construction lender may ignore an unbonded stop payment notice, refuse to withhold construction loan funds, and continue to disburse funds to the project owner without concern over incurring personal liability to the claimant. However, no statute provides that a contractor is barred from *enforcing* an unbonded stop payment notice to the extent a construction lender continues to hold undisbursed construction loan funds. In fact, certain stop payment notice statutes indicate that a claimant could, in fact, enforce an unbonded stop payment notice against a construction lender to the extent the construction loan funds remain undisbursed to the project owner.

First, Civil Code, §8540 (see former Civil Code, §3167), setting forth the priority of payment where multiple stop payment notice claims have been filed, provides that claimants who gave a bonded stop payment notice should be paid first and claimants

who gave an unbonded stop payment notice should be paid after the claims in the first group have been satisfied. Importantly, the statute does not limit payment to unbonded stop notice claimants to only those whose claims are asserted against the project owner. It states only "funds withheld … will be distributed in the following order of priority …." If an unbonded stop payment notice could not be enforced against a construction lender, the statute would indicate that the order of distribution for unbonded stop payment notices would not apply to a construction lender. The absence of any distinguishing language between claims made against project owners and claims made against construction lenders indicates that an unbonded stop payment notice may be enforced against a construction lender.

Second, Civil Code, §8536 (see former Civil Code, §3162, subd. (a)) provides that a construction lender may decline to withhold construction loan funds upon receipt of an unbonded stop payment notice but does not provide that an unbonded stop payment notice is unenforceable against a construction lender. To the extent a construction lender does not fully disburse construction loan funds to the project owner to pay for the hard costs of construction, any such funds remaining held by the construction lender potentially could be reached in an action to enforce an unbonded stop payment notice.

Third, Civil Code, §8538 (see former Civil Code, §3159, subd. (a)(3)) provides that a claimant who has given a construction lender a stop payment notice may make a written request that the construction lender advise the claimant whether the construction lender has elected to withhold construction loan funds in response to the unbonded stop payment notice under Civil Code, §8536.[41] The lender must provide written notice within 30 days if it has elected to not withhold funds in response to the unbonded stop payment notice.

The existence of the statute is a strong indication that if a construction lender does withhold construction loan funds (and advises the claimant accordingly), the claimant may proceed to enforce its unbonded stop payment notice against the construction lender to the extent of withheld construction loan funds. If a claimant could never successfully file an action to reach the withheld construction loan funds, there would be no reason for Civil Code, §8538 to exist, nor would there be a need to advise a claimant of a construction lender's election to withhold construction loan funds. Whether or not the construction lender decided to withhold funds would make no difference, since either way the claimant could not enforce its unbonded stop payment notice. One could infer from the existence of Civil Code, §8538 that an unbonded stop payment notice claimant may successfully file an enforcement action to the extent the construction lender has not disbursed construction loan funds to the project owner. However, a possible contrary inference is that Civil Code, §8538 simply creates a mechanism for claimants to determine whether the a lender will withhold funds in response to an unbonded stop payment notice so that the claimant can make an informed decision whether to proceed with the expense of serving a bonded stop payment notice.

Fourth, Civil Code, §8542 (see former Civil Code, §3159, subd. (b)) provides that "[i]f funds are withheld pursuant to a stop payment notice given to a construction lender by a *direct contractor* or a subcontractor …" then the direct contractor or subcontractor may recover only the net amount due after deducting funds withheld in

response to claims of other lower tier claimants who have also given stop payment notices. In other words, this section provides that if a construction lender withholds construction loan funds in response to a stop payment notice, then recovery by an upper-tier claimant will be limited to the amount of its claim, minus the claims of its lower-tier contractors and suppliers. This section does not limit a claimant's recovery against a construction lender only to situations where a claimant has served a bonded stop payment notice. Instead, this statute refers generically to a stop payment notice. This general reference encompasses both bonded stop payment notices and unbonded stop payment notices.[42] Therefore, Civil Code, §8542 effectively provides that a claimant may enforce an unbonded stop payment notice to the extent the construction lender has withheld construction loan funds. If the Legislature intended for only bonded stop payment notices to be enforceable against construction lenders, Civil Code, §8542 would have been drafted to make clear that it was limited only to situations where a bonded stop payment notice was served on a construction lender. The absence of any such limiting language is a strong indication that the Legislature intended unbonded stop payment notices to be enforceable against construction lenders to the extent construction loan funds have not been disbursed to the project owner.

Fifth, Civil Code, §8544 (see former Civil Code, §3166) provides that the rights of a claimant who has given a construction lender a stop payment notice are not affected by the project owner's assignment of the construction loan fund. The reference to a stop payment notice, and not a bonded stop payment notice, given to a construction lender is yet a further indication that a claimant may enforce an unbonded stop payment notice given to a construction lender.

Finally, Civil Code, §8550 (see former Civil Code, §3172), which governs the time to file a stop payment notice enforcement action, does not distinguish between an unbonded stop payment notice and a bonded stop payment notice. Again, if an unbonded stop payment notice could not be enforced against a construction lender, presumably the legislature would have included appropriate limiting language in Civil Code, §8550. Instead, §8550 indicates that a claimant may file an action to enforce any type of stop payment notice (whether bonded or unbonded) against any type of fund holder (whether the project owner or construction lender).

In sum, the statutory language of the stop payment notice statutes indicates that a claimant may enforce an unbonded stop payment notice to the extent there remain any construction loan funds not previously disbursed to the owner/borrower to pay for the hard costs of construction. The suggestion in *Connolly* that the construction lender may disregard the unbonded stop payment notice is not inconsistent with this conclusion. The holding in *Miller* to the effect that a construction lender may avoid an unbonded stop payment notice by exercising an assignment of a construction loan fund and paying to itself all sums not previously disbursed to the borrower may no longer be viable in light of current Civil Code, §8544, which by use of the generic reference to a "stop payment notice" rather than a "bonded stop payment notice" indicates that an unbonded stop payment notice is "unaffected" by an assignment of a construction loan and that an unbonded stop payment notice takes priority over any such assignment.

VI. *FAMILIAN CORP. V. IMPERIAL BANK* AND *BREWER CORP. V. POINT CENTER FINANCIAL, INC.* AND THE EFFECT OF AN UNBONDED STOP PAYMENT NOTICE ON INTEREST RESERVE FUNDS

On the face of things, if enforceable only in the manner discussed above, an unbonded stop payment notice would be of limited utility. In the great majority of situations, construction loans are fully disbursed over the loan term. If a construction lender simply ignored an unbonded stop payment notice, and continued to disburse construction loan funds to the owner/borrower, at the end of the construction project there would be nothing left for the unbonded stop payment notice to attach to. However, the Fourth District Court of Appeal's opinions in *Familian Corp. v. Imperial Bank* ("*Familian*") and *Brewer Corp. v. Point Center Financial, Inc. ("Brewer")* would appear to establish, in effect, that if an unbonded stop payment notice could not be avoided by a construction lender exercising an assignment of the loan fund as contemplated in this article, then there will almost always be a pool of money for an unbonded stop payment notice claimant to seek from a construction loan fund.[43]

Current construction lending practice almost always includes an "interest reserve" component in any construction loan. Construction lenders typically allocate a portion of the construction loan fund to payment of interest that accrues during the course of the construction loan term. As the borrower draws funds from the construction loan to pay contractors, the lender charges interest on the construction loan funds disbursed. The construction lender will draw funds from the portion of the construction loan fund allocated to pay accrued interest and use those funds to pay interest generated since the last loan disbursement. The funds drawn from the interest reserve and applied to accrued interest will then add to and increase the outstanding loan balance. Both *Familian* and *Brewer* hold, in essence, that an interest reserve constitutes an "assignment" of construction loan funds and therefore is subject to stop payment notice claims.

In *Familian*, a construction lender loaned $3.8 million to finance construction of condominium units. The loan was secured by a deed of trust. The loan agreement required that a portion of the loan funds be segregated into a pre-allocated interest reserve account. As construction proceeded, the lender disbursed to itself interest, fees, and expenses totaling $528,000 from the pre-allocated interest reserve account. The lender received bonded stop payment notices totaling $105,000 at a time when approximately $188,000 remained in unexpended loan funds. The construction lender later received additional stop payment notices totaling $427,000. The construction lender interpled the $105,000 withheld upon receipt of the first bonded stop payment notice and argued that the stop payment notice claimants were entitled to recovery of that amount only.

Familian Corp., a plumbing materials supplier, was one of the bonded stop payment notice claimants. It moved for summary judgment, arguing that funds disbursed to the construction lender from the pre-allocated interest reserve account were subject to its bonded stop payment notice. The trial court granted summary judgment in favor of *Familian*, holding that the pre-allocation and segregation of

construction loan funds was an assignment within the meaning of former Civil Code, §3166 that did not take priority over the claims of the stop payment notices.

The appellate court agreed with the trial court. It reasoned that the stop payment notice statutes were intended to protect claimants, whose "credit risks are not as diffused as those of other creditors," who "extended a bigger block of credit, … have more riding on one transaction … and have more people vitally dependent upon eventual payment [and] have much more to lose in the event of default."[44] In contrast, a secured construction lender is protected by a first priority encumbrance on property that has increased in value as a result of the claimant's efforts, and by the terms of a loan agreement that allows the construction lender to control the loan funds. The Appellate Court determined that the anti-assignment provision of former Civil Code, §3166 "must be liberally construed to affect its objects and to promote justice. [Citations.]"[45] Therefore, the Appellate Court held that pre-allocating construction loan funds into an interest reserve account for disbursement to the lender was an assignment within the meaning of former Civil Code, §3166 and as such the assignment did not take priority over Familian Corp.'s bonded stop payment notice.[46]

Brewer reaffirmed *Familian.* In *Brewer*, the construction lender was a licensed real estate broker who entered into a $13.625 million construction loan with a condominium developer. The construction loan provided that the lender was obligated to raise $2.8 million in loan funds at the close of the transaction and to use its "best efforts" to raise the balance in stages. The construction lender solicited third-party investors to participate in the construction loan. The investors provided money to the construction lender and, in turn, the construction lender assigned a beneficial interest in a portion of the construction loan deed of trust to the investors, entered into a loan servicing agreement with the investors, paid each investor its pro rata share of interest, and charged the investors a loan servicing fee. The construction lender retained only a 2.99% interest in the construction loan. Investors held the remaining 97.01% interest.

During the term of the construction loan, the construction lender disbursed $1,555,771.37 from the construction loan fund to pay interest, loan fees, and points to itself and its investors. In June 2007, contractor Brewer Corp. served a bonded stop payment notice on the construction lender. At the time of Brewer Corp.'s stop payment notice, the construction lender held enough undisbursed construction loan funds to satisfy Brewer Corp.'s claims. The construction lender ignored Brewer Corp.'s bonded stop payment notice and continued to disburse construction loan funds to the borrower/developer. After the construction lender had disbursed fully the construction loan fund, three other contractors served bonded stop payment notices on the construction lender. All four contractors filed actions to enforce their bonded stop payment notices.

Relying on *Familian*, the trial court ruled that the contractors' bonded stop payment notices took precedence over the construction lender's distribution of construction loan funds to itself (and its investors) to pay accrued interest and awarded payment of $1,555,771.37 to the contractors. Because the award was not sufficient to pay all of the claims, the trial court also ordered that the award be

apportioned among the claimants pursuant to former Civil Code, §3167 (now Civil Code, §8540).[47]

The construction lender appealed, arguing primarily that *Familian* was wrongly decided and should not be followed. The appellate court agreed with the trial court and held that *Familian* was decided correctly and was binding authority. The appellate court held that construction loan funds are intended solely for construction costs and that a construction loan should not be used to pay "ordinary expenses." Therefore, a construction lender's disbursement of construction loan funds to itself to pay interest constituted an "assignment" under former Civil Code, §3166 (now Civil Code, §8544) and such disbursements were subject to "claw back" to satisfy the bonded stop payment notice claims.

The construction lender next argued that *Familian* was distinguishable from its case and therefore should not be followed, raising two major points. First, the construction lender argued that in *Familian,* the lender had foreclosed on its deed of trust and terminated any mechanics lien, so refusing the stop payment notice claim would unjustly enrich the construction lender with a "double recovery." Here, the construction lender's deed of trust was terminated by foreclosure of a more senior deed of trust, so there was no potential for a "double recovery." The appellate court found this to be a distinction without a difference. The anti-assignment provisions of former Civil Code, §3166 (now Civil Code, §8544) do not depend on whether foreclosure has occurred or whether the lender ultimately makes a profit. Therefore, this distinction was immaterial.

Next, the construction lender argued that *Familian* was distinguishable because there the lender had segregated the construction loan fund into a variety of pre-allocated accounts whereas in the current situation the construction lender had not done so. The appellate court acknowledged this distinction but recognized that the segregation of money into different accounts did not factor into the *Familian* analysis. Instead, the analysis in *Familian* turned on whether there had been a pre-allocation of loan funds. The *Familian* court held that the "pre-allocation of construction loan funds and periodic disbursements to the lender are assignments within the meaning of §3166."[48] Accordingly, the absence of a segregated account was not a significant enough distinguishing characteristic to cause the Court to refuse to follow *Familian.*

The bottom-line expressed in both *Familian* and *Brewer* is that construction loan funds allocated to interest reserve constitute invalid assignments and will almost always be subject to the claims of a stop payment notice claimant.

Following the logic of *Familian* and *Brewer* and the language of Civil Code, §8544, a contractor who has given an unbonded stop payment notice may be able to argue successfully that its unbonded stop payment notice attaches to the portion of a construction loan allocated to pay accrued interest. Both *Familian* and *Brewer* determined that pre-allocation and distribution to a construction lender of an interest reserve component of a construction loan constituted an invalid assignment under former Civil Code, §3166 (see current Civil Code, §8544) and was therefore subject to bonded stop payment notice claims. Former Civil Code, §3166 and current Civil Code, §8544 are effectively identical; neither distinguish between bonded and unbonded stop payment notices. Therefore, the logic expressed in both *Familian*

and *Brewer* should apply equally to bonded and unbonded stop payment notices and a claimant who gives an unbonded stop payment notice to a construction lender should be able to pursue a claim against the portion of the construction loan preallocated for disbursement to the lender to pay-down accrued interest (to the extent such funds were not exhausted by bonded stop payment notice claims).[49]

VII. CONCLUSION

While there is no case law on point, the current stop payment notice statutes include several indications that a claimant giving an unbonded stop payment notice may enforce its claim against the portions of a construction loan not disbursed to the borrower to pay for hard costs of construction. Of particular concern to construction lenders is the fact that an unbonded stop payment notice may be utilized to reach interest payments previously made to a construction lender from the interest reserve portion of a construction loan. Until either the Legislature or the courts have provided clarity on the extent to which an unbonded stop payment notice may be enforced, cautious construction lenders should treat unbonded stop payment notices as valid potential claims against the portion of a construction loan that has not been disbursed to the borrower to pay for the construction of improvements.

NOTES

1. Unless noted otherwise as used herein, the term "stop payment notice" refers to stop payment notices for private works.
2. See *Familian Corp. v. Imperial Bank*, 213 Cal. App. 3d 681, 262 Cal. Rptr. 101 (4th Dist. 1989).
3. See *Connolly Development, Inc. v. Superior Court*, 17 Cal. 3d 803, 809, 132 Cal. Rptr. 477, 553 P.2d 637 (1976).
4. Civ. Code, §8430, subd. (a); *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d at 808.
5. Civ. Code, §8450, subd. (a); *Walker v. Lytton Sav. & Loan Assn.*, 2 Cal. 3d 152, 159, 84 Cal. Rptr. 521, 465 P.2d 497 (1970).
6. Civ. Code, §8450, subd. (a), *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d at 808.
7. See Civ. Code, §8458.
8. Civ. Code, §8450, subd. (a); *Walker v. Litton Savings & Loan Association, supra*, 2 Cal.3d at 159.
9. *Rheem Mfg. Co. v. U.S.*, 57 Cal. 2d 621, 625, 21 Cal. Rptr. 802, 371 P.2d 578 (1962).
10. *Brewer Corporation v. Point Center Financial, Inc.*, 223 Cal. App. 4th 831, 167 Cal. Rptr. 3d 555 (4th Dist. 2014), as modified on denial of reh'g, (Feb. 27, 2014) and review filed, (Mar. 12, 2014).
11. *Connolly Development Company v. Superior Court, supra*, 17 Cal. 3d at 809; *Brewer Corporation v. Point Center Financial, Inc.*, 223 Cal. App. 4th 831, 167 Cal. Rptr. 3d 555 (4th Dist. 2014), as modified on denial of reh'g, (Feb. 27, 2014) and review filed, (Mar. 12, 2014).
12. *Connolly Development Company v. Superior Court, supra*, 17 Cal. 3d at 809.
13. Civ. Code, §8544; *A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n*, 61 Cal. 2d 728, 734, 40 Cal. Rptr. 85, 394 P.2d 829 (1964).
14. *Connolly Development Company v. Superior Court, supra*, 17 Cal. 3d at 809.
15. *Familian Corp. v. Imperial Bank, supra*, 213 Cal. App. 3d at 687-688; *Rossman Mill & Lumber Co. v. Fullerton Sav. & Loan Ass'n*, 221 Cal. App. 2d 705, 709, 34 Cal. Rptr. 644 (4th Dist. 1963).

16. *Miller v. Mountain View Sav. & Loan Ass'n*, 238 Cal. App. 2d 644, 656, 48 Cal. Rptr. 278 (1st Dist. 1965).
17. Civ. Code, §§8520, 8530.
18. Civ. Code, §8400.
19. Civ. Code, §8506.
20. Civ. Code, §8520, subd. (a).
21. Civ. Code, §8536.
22. Civ. Code, §§8536, subd. (b), 8532.
23. *Connolly Development Company v. Superior Court, supra*, 17 Cal. 3d at 809.
24. *Connolly Development Company v. Superior Court, supra*, 17 Cal. 3d at 809.
25. *Bohannan Bros., Inc. v. Lo Jean Dev. Co.*, 3 Cal. App. 3d 200, 82 Cal. Rptr. 922 (2d Dist. 1969). Note: This case was decided under a former version of the stop payment notice law that provided a contractor may not file a stop payment notice enforcement action until the period to record a mechanics lien has run. (Former Code Civ. Proc., §1197.1, subd. (a).) As discussed above, under the current statute (Civ. Code, §8550, subd. (a)), this period has been reduced to ten days after the contractor has given the stop payment notice.
26. Civ. Code, §8556.
27. Civ. Code, §8540, subd. (a)(1).
28. Civ. Code, §8540, subd. (a)(2).
29. Civ. Code, §8450, subd. (a)(1), (2).
30. Civ. Code, §8560.
31. Civ. Code, §8558; *Mechanical Wholesale Corp. v. Fuji Bank, Ltd.*, 42 Cal. App. 4th 1647, 1661, 50 Cal. Rptr. 2d 466 (2d Dist. 1996).
32. *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d 803.
33. *Miller v. Mountainview Savings and Loan Association, supra*, 238 Cal. App. 2d 644.
34. *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d at 809.
35. *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d at 809.
36. Under former case law a claimant could, under certain circumstances, impose an equitable lien against the construction loan fund. The legislature abolished the equitable lien remedy in 1967. See *Nibbi Brothers, Inc. v. Home Federal Sav. & Loan Assn.*, 205 Cal. App. 3d 1415, 1420, 253 Cal. Rptr. 289 (1st Dist. 1988). See also Civ. Code, §§8500 and 9350 and former Civ. Code, §3264.
37. See current Civ. Code, §8544.
38. The Appellate Court ultimately upheld the trial court's ruling with respect to imposition of an equitable lien.
39. *Miller v. Mountainview Savings & Loan Association, supra*, 238 Cal. App. 2d at 658.
40. See Civ. Code, §8044, subd. (a)(3).
41. Civ. Code, §8536, subd. (b)(1) provides that construction lender may elect to not withhold funds upon receipt of an unbonded stop payment notice.
42. Civ. Code, §8044, subd. (a)(3) provides that "Except to the extent Title 2 (commencing with §8160) distinguishes between a bonded and an unbonded stop payment notice, a reference in that title to a stop payment notice includes both a bonded and an unbonded notice."
43. This article is not intended to be an endorsement of the logic and reasoning expressed in the *Familian* and *Brewer* opinions or express any opinion on whether *Familian* and *Brewer* were decided correctly.
44. *Familian Corp. v. Imperial Bank, supra*, 213 Cal. App. 3d at 687.
45. *Familian Corp. v. Imperial Bank, supra*, 213 Cal. App. 3d at 685.
46. *Familian Corp. v. Imperial Bank, supra*, 213 Cal. App. 3d at 688.
47. It is not clear from the opinion why Brewer Corp. was subject to apportionment. Since Brewer Corp.'s bonded stop payment notice was given when sufficient loan funds remained to satisfy the claim, the construction lender's failure to withhold funds equal to the amount of the notice should have exposed the construction lender to personal

liability for the entire amount of the claim. (See *Connolly Development, Inc. v. Superior Court, supra*, 17 Cal. 3d at 809.)

48. *Familian Corp. v. Imperial Bank, supra*, 213 Cal. App. 3d at 688.
49. See Civ. Code, §8540, subd. (a), providing that bonded stop payment notice claims take priority over unbonded stop payment notice claims.

Miller & Starr Real Estate Newsalert

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