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Lender Alert

July 2012

California's Revised Mechanics Lien Law: Changes in Rights and Obligations of Construction Lenders

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I. Introduction

California's mechanics lien law provides various rights and remedies to persons who provide labor, service, equipment or material to real property, including the right to record a mechanics lien on the improved work for both site work and construction, the right to recover construction funds from a construction lender pursuant to a stop notice, and the right to recover against a bond guaranteeing payment in the event of default.

The law has been completely rewritten. A few of the provisions took effect on January 1, 2011, but the vast majority became operative on July 1, 2012. The comprehensive revision derives from a 1999 request to the California Law Revision Commission ("Commission") from the Chair and Vice Chair of the Assembly Judiciary Committee asking that the Commission study the mechanics lien law. Ultimately, the Commission published its recommendation, encompassed in a report covering more than 400 pages.[1] The recommendation, with various changes, was subsequently enacted into law.[2] Civil Code Sections 8000-8154 cover works of improvement generally. Civil Code Sections 8160-8848 cover private works of improvement. Civil Code Sections 9000-9566 cover public works of improvement. Various other provisions are scattered elsewhere throughout the California codes.

The reason for the revision was described in the cover letter from the Commission to Governor Schwarzenneger dated February 14, 2008, as follows:

> The mechanics lien law was first enacted in 1850, and existing law still contains language dating back to 1872. Since the last recodification of the statute in 1969, individual provisions have been amended more than 70 times. Over time, the statute has become increasingly difficult to use, generating litigation over confusing provisions, and often leaving participants unsure of their rights and obligations.
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> This recommendation recodifies and clarifies the entire mechanics lien statute. Terminology has been modernized and made more uniform, and inconsistencies have been eliminated. Longer provisions are divided into shorter and more readable provisions, and all provision have been organized in a functionally coherent order.
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> The recommendation does not propose radical changes to the operation of the existing construction law remedies. However, it does add a few substantive improvements designed to make it easier for owners to learn about the existence and validity of a recorded lien, and to challenge a clearly invalid lien.

Some of the revisions, which affect the rights and obligations of construction lenders, are considered below. The changes should not affect the structure of construction lending, but may affect lenders' practices in certain respects.

II. Preliminary Notice

Typically, a person who may seek to recover pursuant to a mechanics lien, a stop notice, or a payment bond must first serve a preliminary 20-day notice on the appropriate parties, including the construction lender or reputed construction lender, if any, which must describe the work to be provided, an estimate of the total price of the work to be provided, and a specified notice. Under the existing statute, persons exempted from that requirement are persons under direct contract with the owner and persons performing actual labor for wages.[3] Under the revised law, a person with a direct contractual relationship with an owner or reputed owner must give the preliminary notice to the construction lender or reputed construction lender, if any.[4] In most construction loans, the borrower who owns the subject property is obligated by the loan documents to inform its lender about the general contractor and any other person it retains to do work on the property. Sometimes—particularly with troubled projects—the borrower may arrange directly with someone else to do work on the property and not inform its lender. Under the revised law, the new contractor will have to inform the lender that it has been retained if it wants to be able to enforce its right to payment pursuant to a mechanics lien or stop payment notice.

III. Priority of Optional Advances

Civil Code Section 3136, as it existed prior to July 1, 2012, stated that a mortgage or deed of trust which would be prior to a mechanics lien to the extent of obligatory advances shall also be prior to a mechanics lien "as to any other advances, secured by such mortgage or deed of trust, which are used in payment of any claim of lien which is recorded at the date or dates of such other advances and thereafter in payment of costs of the work of improvement. Such priority shall not, however, exceed the original obligatory commitment of the lender as shown in such mortgage or deed of trust." That section, if read literally, means that, in order

for the lender to retain priority, funds advanced while the borrower is in default (assuming the default makes the advance optional) must first be used to pay off existing recorded mechanics liens before they can be used to pay for construction.

Revised Civil Code Section 8456 eliminates the requirement that the optional advance be used to pay existing mechanics liens. That section says that "An optional advance of funds by the construction lender that is used for construction costs has the same priority as a mandatory advance of funds by the construction lender, provided that the total of all advances does not exceed the amount of the original construction loan."

IV. Waiver and Release of Mechanics Lien

Civil Code Section 3262, prior to July 1, 2012, prohibited the owner and original contractor from waiving, affecting, or impairing the claims of other persons except by their written consent. The statute said that no oral or written statement purporting to waive, release, impair, or otherwise adversely affect a claim is enforceable or creates any estoppel or impairment of a claim unless (a) it is pursuant to a waiver and release prescribed in that section, or (b) the claimant has actually received payment in full for the claim.

The statute, in its pre-July 1, 2012 form, is unclear on its face whether a general contractor may waive its own mechanics lien claim without utilizing one of the forms set forth in the statute. The California Court of Appeal, however, has interpreted the statute to allow a contractor to waive its own claim when doing so does not affect or impair the claims or liens of other laborers or subcontractors. *Santa Clara Land Title Co. v. Nowack & Associates, Inc.* (1991) 226 Cal.App.3d 1558. In that case, the waiver and release was given to induce a prospective lender to make a new construction loan for the property. Although not expressly discussed, it appears that the general contractor did not use the statutory form for its release. In an unpublished Court of Appeal decision, the Court relied on *Santa Clara Land Title* and held that it was not necessary for the general contractor to use the statutory form to waive its own claim in a similar situation in which the release and waiver was given to induce a prospective lender to make a construction loan.[5] This can be important because, in some construction loans, the general contractor (referred to as the "direct contractor" in the revised statute) is affiliated with the borrower, and the lender wants to make sure the general contractor cannot assert a claim that would have priority over the lender or the lender's deed of trust. The waivers in those circumstances typically are much broader than the waivers contained in the statutory forms.

Civil Code Sections 8120-8138 of the revised version cover the same subject matter, although the text of the release forms is different than in the existing statute. There is nothing in the statute or the legislative history that discusses the issue described above.

Civil Code Section 8128 of the revised version does resolve an ambiguity in the pre-July 1, 2012 law by clarifying that it is not necessary to use the statutory form for a claimant to waive any stop notice claim (including presumably a stop notice claim served on the construction lender). Civil Code Section 3262(b)(2) in the existing statute says that the statutory form is not necessary to release a stop notice served on the owner, but is silent on whether it is necessary to release a stop notice served on the construction lender.

V. Order for Release of Mechanics Lien

Under both the pre-July 1, 2012 law and the new law, a claimant must commence an action to enforce a mechanics lien within 90 days after recordation, except that time limit may be extended if the owner and claimant agree to an extension of credit, but in no event later than one year after the completion of the work of improvement. If the claimant fails to commence the action within the time limit, the mechanics lien expires and is unenforceable.[6] The owner of the property or any interest in the property may petition the court to release the property from the claim of lien if the claimant has not commenced the action within the specified time limit.[7] Under the pre-July 1, 2012 law, the prevailing party in such an action is entitled to attorney's fees not to exceed $2,000.[8] Under the revised law, the prevailing party is entitled to reasonable attorney's fees, with no cap.[9]

VI. Stop Payment Notice

The revised statute leaves the stop notice procedure in the existing mechanics lien law largely in place, although it changes the applicable term from "stop notice" to "stop payment notice." The basic concept behind a stop notice is that a construction lender who receives a bonded stop notice from a person who provided labor, services or materials to a work of improvement is obligated to withhold construction funds in an amount sufficient to cover the stop notice.[10] Under the revised statute, the amount claimed in the stop payment notice may include only the amount due the claimant for work provided through the date of the notice.[11]

Conceptually, a bonded stop notice served on a lender should only reach construction funds that remain undisbursed at the time the bonded stop notice is received by the lender. In *Familian Corp. v. Imperial Bank* (1989) 213 Cal.App.3d 681, however, the Court of Appeal held this is not necessarily so. In that case, the Court held that payments the construction lender received from the construction fund for fees, points and interest should be considered part of the construction funds existing at the time the stop notice is received even if those payments were payable and paid to the lender prior to the lender's receipt of the bonded stop notice.

In so holding, the court relied on Civil Code Section 3166, which states:

> "No assignment by the owner or contractor of construction loan funds, whether made before or after a stop notice or bonded stop notice is given to a construction lender, shall be held to take priority over the stop notice or bonded stop notice, and such assignment shall have no effect insofar as the rights of claimants who give the stop notice or bonded stop notice are concerned."

In *Familian*, the Court concluded that, for the purposes of this section, the term "assignment" includes not only fees, points and interest placed in a reserve account and not yet earned, but also fees, points and interests that were earned and paid to the lender before the claimant commenced work on the project. Accordingly, the Court held, any such fees, points and interest are to be considered part of the construction loan funds and subject to a bonded stop notice. The Court held that, if there are insufficient, undisbursed construction loan funds available to satisfy a bonded stop notice, the construction lender is obligated to disgorge fees, points and interest that have previously been paid to it to the extent necessary to satisfy the bonded stop notice.

The result in *Familian* appears to be wrong to the extent that it applies to payments earned and paid to the lender prior to the service of the bonded stop notice. The error was recognized in *Steiner and Company, Inc. v. Citicorp Real Estate, Inc.* (1999) 85 Cal.Rtpr.2d 38, in which the Court of Appeal said that such an interpretation is contrary to the ordinary meaning of the word "assignment," which the Court described as "a transfer of a right to something that has not yet become property in possession." In addition, although the Court in *Steiner* did not point this out, the definition of "assignment" used by the Court in *Familian* is so broad that it would mean that any payment by the construction lender from construction loan funds to anyone (including another contractor or subcontractor) would be considered an assignment and subject to disgorgement for the benefit of the stop notice claimant. The California Supreme Court granted review in *Steiner,* which had the effect of causing the Court of Appeal decision to be depublished. The Supreme Court subsequently dismissed the review, but refused to allow *Steiner* to be published. Accordingly, *Steiner* may not properly be cited.

The *Familian* ruling has been applied to transactions in which the construction loan was structured as a line of credit, when the loan agreement stated that a specified portion of the line of credit was to be used as an interest reserve to pay interest as it became due on the note. In one such case, the California Court of Appeal, in an unpublished decision, affirmed the trial court's application of the *Familian* ruling in that factual situation, despite the submission of amicus briefs filed by the California Bankers Association, the Western Independent Bankers, and the California Mortgage Association in favor of the lender. In so holding, the Court of Appeal said "The legal principles set forth in *Familian* have remained intact for more than 20 years. The Bank and the amici curiae have provided no compelling reason to deviate from those long-standing legal principles."[12] Review by the California Supreme Court was not requested.

The revised mechanics lien law rewrites Civil Code Section 3166, to read as follows: "The rights of a claimant who gives a construction lender a stop payment notice are not affected by an assignment of 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."[13] There is nothing in this text, the California Law Revision Commission report, or the legislative history of the statute, that indicates any attempt to either affirm the correctness of the *Familian* case or change the result.

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[1] *Mechanics Lien Law,* 37 Cal.L.Revision Comm'n Reports 527 (2007) (Publication #230).
[2] SB 189 (2009-2010 Session), amended by SB 190 (2010-2011 Session).
[3] Civil Code Section 3097 (prior to July 1, 2012).
[4] Civil Code Section 8200 (revised).
[5] *Monterey Bay Equity Corporation v. Comerica Bank* (Cal.Ct.App. Third App.Dist. Case No. C063720, July 12, 2011))
[6] Civil Code Section 3144 (pre-July 1, 2012); Civil Code Section 8460 (revised)
[7] Civil Code Section 3154 (pre-July 1, 2012; Civil Code Section 8480 (revised)
[8] Civil Code Section 3154(g) (pre-July 1, 2012)
[9] Civil Code Section 8488 (revised)
[10] Civil Code Section 3159 (pre-July 1, 2012); Civil Code Section 8536 (revised); Civil Code Section 9358 (revised)
[11] Civil Code Section 8502 (revised); Civil Code Section 9352 (revised)
[12] *Paveco Construction, Inc. v. East West Bank* (Cal.Ct. App. Second App.Dist. Case No. B223912 (May 5, 2011))
[13] Civil Code Section 8544 (Revised)