BY ROBERT G. CAMPBELL

Stop Notice Risks for Construction Lenders

CONSTRUCTION LENDERS FACE MYRIAD CHALLENGES in the plunging economy and real estate market. The difficulties include handling a heightened number of borrower defaults, deciding whether to continue disbursing construction loan funds in a declining market, and determining how to weigh the risks of foreclosing and completing construction on an incomplete project. While navigating these obstacles, lenders should always evaluate their potential liability to contractors and suppliers for bonded stop notices.

By serving a bonded stop notice claim on the lender, contractors and suppliers can effectively lien any undisbursed construction loan funds. The failure of a construction lender to honor a proper stop notice can result in substantial exposure. Construction lenders that ignore a bonded stop notice claim on a private work of improvement[1] do so at their peril.

A stop notice is a written and verified statement served by a claimant owed money on a work of improvement. The statement must identify the claimant and describe the nature of the labor, materials, or services provided; the name of the party to whom these were furnished; the dollar value of what was furnished; and the amount claimed as due.[2] By serving a valid stop notice on a construction lender, a stop notice claimant creates a claim or lien on undisbursed construction funds in the hands of an owner or lender for the benefit of the claimant. This remedy allows contractors, subcontractors, and materialmen to reach undisbursed construction loan proceeds as security against nonpayment.[3] Once a bonded stop notice is served, the lender must withhold from available construction funds an amount sufficient to pay the stop notice claim and may not use that withheld amount to pay down the principal amount of the loan or to pay interest, fees, or other costs.[4]

"A bonded stop notice" is defined as a stop notice given to a construction lender that is accompanied by a bond in a penal sum equal to 1.25 times the amount of the claim.[5] A construction lender is only obligated to withhold funds from an owner/borrower if properly served with a bonded stop notice. Indeed, a construction lender is not obligated to honor a stop notice that is not bonded.[6] The construction lender must withhold funds pursuant to a bonded stop notice served by an original contractor, subcontractor, or first-tier supplier.

The stop notice claimant also may demand in its stop notice that the lender provide a copy of any payment bond.[7] If there is a payment bond recorded for the project, different rules apply. When a payment bond has been recorded, the lender is not required to withhold funds but may do so at its option.[8] This applies to all proper claimants other than the original contractor. Similarly, an owner served with a stop notice is not required to withhold funds when a payment bond has been recorded but may do so at its option.[9] If an owner declines to withhold funds in response to a stop notice because a payment bond has been recorded, then the owner must furnish the claimant with a copy of the payment bond.

A valid stop notice can be a highly effective remedy for a claimant seeking to obtain payment for its work. A lender that improperly disburses funds subject to a stop notice is personally liable for the amount due to the lien claimant under the contract with the owner (but not exceeding the maximum amount of unexpended construction funds).[10] Further, the stop notice remedy is independent and cumulative of a claimant's rights to a mechanic's lien, to enforce any payment bond, and to pursue a writ of attachment.[11] Thus a claimant may avail itself of all prejudgment remedies simultaneously.

Like mechanic's liens, stop notices are nonconsensual and do not require prior judicial approval. Moreover, lien and stop notice rights may not be waived by contract, reflecting a strong public policy favoring payment for those who improve property. Similarly, no assignment by the owner or contractor of construction loan funds—whether made before or after service of a stop notice on a construction lender—has priority over the stop notice claimant. Assignments cannot defeat the rights of stop notice claimants.[12]

While certain deadlines are strictly enforced, other requirements are liberally construed in favor of the stop notice claimant.

Stop notices differ from mechanic's liens in that they attach to the funds of the owner of the property, or the construction loan proceeds from a lender, rather than to the real property being improved.[13] As a result, a stop notice survives a foreclosure of the property. Thus, stop notices do not give rise to the priority issues regarding the construction lender's deed of trust that emerge with mechanic's liens.[14] If several stop notices have been filed and not enough money exists to pay them all, stop notice claimants share pro rata in the available funds.[15]

Limitations and Requirements

Statutes limit who can assert a stop notice. In general, California law provides that all persons and entities qualified to record a mechanics' lien, with the exception of the general contractor, may serve a stop notice on the owner. This includes materialmen, subcontractors, first-tier suppliers, equipment lessors, licensed design professionals, union trust funds, and those who make improvements to the site.[16] These same classes of claimants, plus the general contractor, may serve a stop notice on the construction lender. Only when the stop notice is bonded is the lender required to withhold funds.

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Stop notice claimants need not wait until their work is complete to serve a stop notice. This is in contrast to mechanics' lien claimants, who must wait until their work or the overall work of improvement is complete. Nevertheless, stop notice claimants must take numerous technical steps to ensure that their stop notices are valid. They must serve a proper 20-day preliminary notice in a timely manner. Service must take place "prior to the expiration of the period within which [the claimant's] claim of lien must be recorded under [Civil Code] Section 3115, 3116, or 3117."[17] These sections calculate the expiration of the service period as a specified number of days after the completion of the work of improvement or the recordation of a notice of completion.

In most cases, owners or lenders have not recorded or served valid notices of completion for completed projects. When that happens, claimants have 90 days from completion of the project to serve a stop notice. That period is shorter when a valid notice of completion has been recorded and served, or when a valid notice of cessation has been recorded.[18] Claimants must pay careful attention to these prerequisites to perfect their stop notice rights.

If owners or lenders dispute the validity of the stop notice, they must post a stop notice release bond in an amount 1.25 times the amount of the stop notice. Only upon the filing of the bond, which has the effect of providing substitute security for the claim of the stop notice claimant, can the withheld funds be released.[19]

Similar to a mechanic's lien claimant, a stop notice claimant must take prompt legal action to enforce the stop notice. An action to enforce the stop notice may be commenced at any time after 10 days following service of the stop notice but no later than 90 days following the period in which a mechanic's lien could be recorded. If no action is commenced within the prescribed period, the stop notice ceases to be effective, and withheld funds must be paid to the person to whom the funds are owed. If an action is commenced, notice must be given within five days.[20] When multiple actions to enforce a stop notice are filed, a motion to consolidate may be filed so that the actions will be adjudicated together in one proceeding.[21]

A significant distinction between a mechanic's lien foreclosure action and a stop notice enforcement action is the right of bonded stop notice claimants to recover their attorney's fees if they are determined to be the prevailing party.[22] By statute, prevailing party claimants also will be awarded interest at the legal rate. Interest accrues from the date of service of the stop notice.[23]

Construction lenders facing a stop notice claim should understand that the statutes governing stop notices are remedial and are liberally construed to effect their objectives and to promote justice. Therefore, while certain deadlines are strictly enforced (such as the deadline for a claimant to commence legal action to enforce a stop notice), other requirements are liberally construed in favor of the claimant.[24] Stop notices are designed to protect materialmen who furnish labor and materials that enhance the value of the property and are supposed to be paid out of the construction fund.[25]

As one court reasoned, a lender's senior deed of trust usually protects the lender from the risk of default.[26] Meanwhile, a lender may protect against the risk of nonpayment of claimants by requiring the owner or developer to post a payment bond. Also the lender can inspect the progress of the construction, issue joint checks, or institute other funding controls. The court further noted that permitting a claimant to recover against the lender for materials and labor contributed to the property is appropriate because those contributions increase the value of the property and therefore enhance the lender's security. In addition, the court declared that strong policy reasons support requiring commercial lenders to police the building industry—and the stop notice remedy encourages this as well.

The purpose of a stop notice is to provide materialmen with protections when they extend their resources in return for a future payment from a construction fund. Most often smaller companies are the ones who file stop notices—companies that have provided labor or materials to a project without the resources to litigate. When balancing the protection of claimants expending their labor and materials against owners or lenders receiving the benefit of those goods and services, the equity scale usually tips in favor of claimants.

Because the stop notice remedy is so highly effective for stop notice claimants, construction lenders have made several attempts over the years to structure a construction loan that effectively circumvents it. In light of the policies in support of the remedy, lenders have not met with much success in trying to defend against stop notices. For example, in a case involving a borrower/owner that assigned to the lender the loan fund under an agreement to make specified progress payments to the contractor, the lender could not defeat a stop notice claim by asserting a right to retain the assigned fund as security for repayment of the loan.[27]

Courts have held that a stop notice will reach an undisbursed loan fund even following a default by the borrower terminating the borrower's right to obtain further disbursements from the loan fund.[28] According to these courts, if a lender could eviscerate the purpose of the stop notice statutes by simply not creating a separate construction fund, then every set of construction loan documents in California would do the same, and bonded stop notices would become ineffective. This result would be contrary to the purpose of stop notices as defined by California courts. To permit lenders to do otherwise would allow them, upon foreclosure of a property, to have the benefits of the provided materials and labor without payment—and deprive lien claimants of any effective remedy.

Stop notice priority extends to all loan funds that remain subject to disbursement—even those that may not be due under the lender/borrower construction agreement because disbursement conditions have not been satisfied. This priority is unchanged even if the borrower is in default.[29] As a consequence, a lender may not properly defeat a stop notice by insisting that no undisbursed funds exist because the borrower is in default and the lender is therefore not obligated to disburse those funds. Private agreements between lenders and borrowers may not serve as a defense to a stop notice claim.

In a seminal decision, *Familian Corporation v. Imperial Bank*,[30] the court refused to allow a lender to preallocate construction loan funds to an interest reserve and thereby effectively subordinate perfected stop notice claims to the interest reserve. The court held that the lender may not pay itself fees, points, and interest in preference to stop notice claimants at the inception of the loan, thus reducing the loan fund and achieving priority over liens or stop notice claimants. This practice violates the antiassignment edict of the stop notice statutes.[31] Lenders also are judicially prohibited from attempting to achieve priority by 1) applying the loan balance to reduce the amount due under the construction note, and 2) depositing unexpended construction loan funds into a general fund or separate escrow account.[32]

Construction Funds and Lender Liability

Conflicts sometimes arise over what constitutes a construction fund. In part this controversy stems from the fact that the California Civil Code does not currently contain a provision specifically defining a "construction fund" for purposes of stop notice claimants. However, former Code of Civil Procedure Section 1190.1(h)—the predecessor to Civil Code Section 3166—defines "construction fund" as the amount either "furnished or to be furnished by the owner or lender…as a fund from which to pay construction costs" or "arising out of a construction or building loan."[33] Civil Code Section 3087 defines a "construction lender" as any mortgagee lending funds to pay for the cost of the work of improvements on a property or a "party holding funds furnished or to be furnished by the

owner or lender or any other person as a fund from which to pay construction costs."

The plain language of the Civil Code and its predecessor in the Code of Civil Procedure broadly treat a construction fund as any amount of money designated to be used to pay construction costs. In both Civil Code Section 3087 and former Code of Civil Procedure Section 1190.1(h), the only requirement for establishing a construction fund is that an amount must be designated as "a fund from which to pay construction costs." Therefore, a construction loan agreement that specifies the loan proceeds as the money for paying construction costs would qualify as a construction fund for the purposes of stop notices.

The amount retained by the lender in response to a bonded stop notice should not be used to pay down the principal amount of the loan or to pay interest, fees, or other costs owed to the lender. A lender that fails to properly withhold undisbursed loan proceeds following a bonded stop notice is personally liable for the amount due to the lien claimant. Nevertheless, the lender will not be liable for more than the amount of the undisbursed loan proceeds at the time the bonded stop notice was served.

Following *Familian*

The *Familian* decision should guide lenders in their response to bonded stop notices.[34] In *Familian*, a construction lender received bonded stop notices that far exceeded the undisbursed loan balance. Meanwhile, the lender had paid itself interest and fees from a reserve account specifically set up to pay interest on the loan and other fees owed to the lender as those amounts accrued. The claimant contested the right of the lender to pay itself from the reserve account before the stop notice was served, and the court agreed with the claimant.

According to the *Familian* court, the practice of payment from an interest reserve constitutes a statutorily prohibited assignment under Civil Code Section 3166. The court held that the lender may not pay itself fees and interest in preference to stop notice claimants. To do otherwise would permit the lender a double recovery by allowing it to capture fees and interest as well as the enhanced value of its property. That enhanced value is created by the construction work performed by the claimants.

The effect of the *Familian* decision is huge, because it can lead to lenders being required to disgorge amounts they have paid to themselves in earned interest and expenses. It also follows under *Familian* that construction lenders with fully disbursed loans remain at risk.

In addition, when a construction loan is sold, a preexisting bonded stop notice claim

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is not defeated by the transfer. The original construction lender served with the bonded stop notice remains obligated. Therefore, construction lenders should procure appropriate indemnities or take other actions to safeguard against this risk when selling a loan subject to a bonded stop notice.

Some have questioned the rationale of the *Familian* decision and consider it poorly reasoned. For example, in *Steiny v. Real Estate, Inc.*, another appellate court disagreed with *Familian*[35] and ruled that a lender was entitled to keep payments made to itself from the loan fund to the extent those amounts were earned prior to service of the stop notice. However, the *Steiny* case was decertified from publication. *Familian*, warts and all, remains existing law and must be heeded by lenders.

Lenders seeking to defend against a stop notice claim should first evaluate whether the prerequisites for a stop notice have been met, such as verifying that the claimant obtained the appropriate bond, gave a proper and timely 20-day preliminary notice, and timely served the stop notice. They should further ascertain that the claimant is among the categories of claimants that possess stop notice rights. Moreover, in the appropriate circumstances, lenders should discern if the claimant was properly licensed. Also, a lender should work with the borrower to determine the merits of the amount claimed to be due and attempt to compel the borrower to resolve the dispute with the claimant. A lender should consider demanding that the property owner secure a stop notice release bond if a legitimate dispute exists.

Ultimately, owner/borrowers and lenders share a strong incentive to keep stop notices from interfering with timely project completion. An incomplete and delayed project increases construction costs and undermines the value of a lender's security. In addition, if a lawsuit is filed to enforce the stop notice and is accompanied by a mechanic's lien foreclosure action, the lender should consider whether to tender the lawsuit to the title insurer. Finally, lenders may need to consider whether to file an interpleader action, in which they may be entitled to recover their attorney's fees. ■

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[1] Stop notices on public works projects are governed by different rules.
[2] Civ. Code §3103.
[3] Civ. Code §3083 (defining "bonded stop notice")and §3103 (defining "stop notice"); Black's Law Dictionary 1432 (7th ed. 1999).
[4] A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n, 61 Cal. 2d 728 (1964).
[5] Civ. Code §3083.
[6] Civ. Code §§3159, 3162.
[7] Civ. Code §3159(a)(3).
[8] Civ. Code §3159(a)(2).
[9] Civ. Code §3161.
[10] Calhoun v. Huntington Park First Sav. & Loan Ass'n, 186 Cal. App. 2d 451 (1960).
[11] Civ. Code §§3158 *et seq*.
[12] Civ. Code §3166.
[13] Connolly Dev., Inc. v. Superior Court, 17 Cal. 3d 803 (1976).
[14] Mechanical Wholesale Corp. v. Fuji Bank, Ltd., 42 Cal. App. 4th 1647 (1996).
[15] Civ. Code §3167.
[16] Civ. Code §3158.
[17] Civ. Code §3160.
[18] Civ. Code §§3115, 3117.
[19] Civ. Code §3171.
[20] Civ. Code §3172.
[21] Civ. Code §3175.
[22] Civ. Code §3176.
[23] *Id*.
[24] Hendrickson v. Bertelson, 1 Cal. 2d 430 (1934); Familian Corp. v. Imperial Bank, 213 Cal. App. 3d 681 (1989).
[25] Rossman Mill & Lumber Co. v. Fullerton Sav. & Loan Ass'n, 221 Cal. App. 2d 705, 709 (1963).
[26] Miller v. Mountain View Sav. & Loan Ass'n, 238 Cal. App. 2d 644 (1965).
[27] A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n, 61 Cal. 2d 728 (1964).
[28] *Id*.
[29] *Id*. at 734.
[30] Familian Corp. v. Imperial Bank, 213 Cal. App. 3d 681 (1989).
[31] Civ. Code §3166.
[32] Familian, 213 Cal. App. 3d at 686.
[33] *See*, *e.g.*, A-1 Door, 61 Cal. 2d at 734 (quoting former Code of Civil Procedure §1190.1).
[34] Familian, 213 Cal. App. 3d 681.
[35] Steiny v. Real Estate, Inc., 85 Cal. Rptr. 2d 38 (1999) (unpublished).