

# Show Me the Money! – California Confirms Scope of Private Lender’s Duty to Withhold Payment Pursuant to Stop Payment Notice



Gregory J. Gangitano  
Partner  
415 986 5900  
[ggangitano@gordonrees.com](mailto:ggangitano@gordonrees.com)

Traditionally, the contractor’s mechanic’s lien remedy on private projects was a highly effective mechanism for securing payment. As large construction loans for financing private projects become the norm, however, the lien remedy has arguably lost some of its potency because loan trust deeds typically take priority over liens. These deeds are usually recorded prior to construction and well in advance of any payment claim. They often wipe out competing lien claims where the value of unpaid loan amounts exceeds the value of the work of improvement.

However, the private works stop notice (now referred to as “stop payment notices” under the July 2012 changes to the code) is a practical and powerful tool for making sure undisbursed loan funds don’t disappear before they’re spent. Under California law, if a lender fails to withhold funds required by the bonded stop notice, it is personally liable to the claimant for the full amount of the claim. But what happens when the lender pre-allocates itself interest, loan points, and underwriting fees at the inception of the loan, before the work even starts? Can these funds be recouped by the stop notice claimant after the work is finished? The February 2014 California appellate decision of *Brewer Corp. v. Point Center Financial, Inc.* confirms that stop notice claims still have priority over such self-paid funds. While nothing prevents borrowers and lenders from pre-allocating interest, points, fees and other related costs from the undisbursed construction loan, courts have the power to reclaim such funds to satisfy a stop payment notice claim.

*Brewer Corp.* involved a private condominium project in San Diego. The owner borrowed more than \$13 million to finance construction. Pursuant to the private loan placement and fee agreements, the lender pre-paid itself interest, loan fee/points, loan underwriting and other fees in excess of \$1.5 million. Various contractors served bonded stop payment notices. However, the lender disbursed the loan funds before satisfying the stop notice claims. The stop payment notice claimants filed actions based on the improper disbursement of funds. They argued such funds should have been used to satisfy their claims.

The primary issue was whether the claimants could recoup interest, fees and other expenses that the lender paid itself pursuant to agreements with the borrower and other third-party investors. Pursuant to these agreements, the lender pre-allocated such amounts to itself from the undisbursed construction loan proceeds. The claimants argued that this

action constituted an illegal assignment of construction funds in violation of former California Civil Code section 3166 (now Civil Code section 8544). Section 8544 provides, “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.”

The lender asserted various creative arguments to establish that the pre-allocation of funds was not an improper assignment. It claimed that the disbursements to itself were contractual interest payments under the loan agreement, which the borrower was required to make, that the disbursements were made before the stop payment notices were received, and that the statutory prohibition of assignment of construction loan funds only applies to unexpended amounts. The court noted that while some of these arguments had “superficial appeal,” none of them demonstrated that the funds in question were anything other than assigned funds earmarked to pay for construction. Neither the timing of the disbursements nor the manner in which the lender characterized them (i.e., contractual payments by the borrower) mattered.

Relying on California cases that previously addressed assignments of construction funds in violation of Civil Code section 8544, the court first noted the policy behind providing contractors, laborers and materialmen with priority over such assignments. The court explained that such parties “are in a particularly vulnerable position. Their credit risks are not as diffused as those of other creditors. They extend a bigger block of credit, they have more riding on one transaction, and they have more people vitally dependent upon eventual payment. They have much more to lose in the event of default.”

The court then explained that reading the code as preventing the court from recapturing such pre-paid funds would effectively give lenders and borrowers the ability to eliminate a stop notice claimant’s rights by assigning away significant portions of construction loans before the work even started. Nor did it matter whether the lender had actually “earned” such fees or interest, or whether the lender would suffer a loss if it did not pre-allocate such funds to itself. The court noted that while the law does not prevent lenders from drafting loan agreements that pre-allocate funds to themselves, such “contractual priority cedes to a stop notice claimants’ statutory priority, allowing a court to reach back to funds a lender has disbursed to itself as a source to pay stop notice claimants.” The court held that the lender was liable for the amount of the pre-allocated interest, points and fees.

*Brewer Corp.* is an important decision because it confirms effectiveness of the bonded stop notice as a tool to secure payment, particularly where lenders’ priority deeds of trust trump mechanic’s lien rights. Furthermore, it provides significant insight into the court’s views on which parties to the construction process are most vulnerable in the event of loan or payment defaults, as well as which parties are in the best position to diffuse resulting risk and losses. It also underscores two central concepts involved in perfecting and defending against stop payment notice claims – the availability of construction funds, and timely notice of the payment claim.

Gordon & Rees LLP regularly counsels clients on stop payment notice claims and the construction payment process.