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Brewer Corp v. Point Ctr. Fin., Inc.

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Brewer Corp. v. Point Ctr. Fin, Inc. (2014) 223 CA4th 831

There is a lot of skirmishing between lenders and contractors as to who has priority when the project is not worth enough to support the claims of both groups. The decision below gives the mechanics and materialmen an enormous leg up unless the lenders are able to come up with a new way to stay on top.

Stop Notices Versus Preallocated Disbursements

The opinion in *Brewer Corp. v. Point Ctr. Fin., Inc.* (20140 223 CA4th 831 has a nostalgic flavor to me because it so reminds me of the general history of mortgage law, even though it deals with the effectiveness of stop payment notices in the construction field rather than with any substantive mortgage doctrine. The court's determination that stop notice claimants should be given priority over construction loan deeds of trust - even though those deeds of trust were recorded and their funds were disbursed first by the construction lenders - was, to me, just a repetition of the way mortgagors are protected notwithstanding all the steps their mortgagees may have taken them such protection. Stop notice claimants have the same kind of "superior equities" that mortgagors have, although their rights play out in the priorities arena rather than in foreclosure.

The Endless Go-Round in Mortgage Law

Some 700 years ago, mortgages always provided for the complete forfeiture of the debtor's property on her default—regardless of how trivial her default or how valuable her property. Such "strict" foreclosure practice was intended to be brought to a halt when the chancery courts began to allow debtors to "redeem" their properties from default by being allowed to pay their debts late, despite the deadlines in their documents. *(Round One.)*

This invention of the equity of redemption was immediately challenged by the lenders, who responded by inserting clauses into their mortgages that "waived" all of their debtors' rights. Chancery courts then had to come up with a companion doctrine—the rule against "clogging"—invalidating those waivers, to keep their equity of redemption from vanishing because of the fine print in the loan documents. *(Round Two.)*

That did not end the battle between the lenders and the courts; it merely relocated the battleground. If lenders could not put effective clauses into mortgage documents, they began drafting documents that did not look like mortgages. Nonmortgages carry the benefit of contract law construction (e.g., freedom of contract, mutual intent, the four corners of the document) and thereby escape the burdens of mortgage law (equity of redemption and anticlogging). That practice forced the courts to respond by deciding that some documents could be mortgages, even though they said they weren't. (So CCP §744 provides: "A mortgage of real property shall not be deemed a conveyance, whatever its terms....")

That *(Round Three)* still continues. Since lenders are as fully convinced of the rightness of the claim to have their loans repaid as judges are of the rightness of debtors to not suffer forfeitures, neither side is likely to ever give up. Since they are also well matched, mortgage lawyers will probably always find employment.

The Priority Fight in the Construction Field

A similar battle rages between the contractors who construct properties and the construction lenders who finance their activities: When the finished project lacks sufficient value to reimburse all those who contributed to it, who should be paid first? Because the money was loaned before construction began, the construction lender's deed of trust was both executed and recorded first, before the contractors did any work, giving it a natural, temporal priority over those claims. The construction claimants came in second, so they should lose. *(Round One.)*

However, legislatures are as sympathetic to contractors (even though they are creditors) as chancery courts were to debtors. Every jurisdiction has mechanics lien statutes that attempt to give contractors superpriority, allowing them to backdate their liens to the commencement of any construction rather than to when they were not paid. Although this may do tradespersons some good against judgment creditors, it does not help that much against their real rival, the construction lenders. Construction lenders have found it easy to stay in front by prerecording their deeds of trust and by making certain that their loans are not funded until they are sure that no work has commenced. Thus, the backdating of mechanics liens does not threaten the construction lender and its foreclosure of the construction loan deed of trust wipes out the mechanics liens. *(Round Two.)*

In response to the failure of that protective remedy to work, California (and some dozen other states) have taken another step, creating the stop notice (now officially called the stop payment), which gives contractors a sort of lien on the loan funds themselves that they may be able to reach even when their mechanics liens on the property have been eliminated by the lender's foreclosure. The construction lender who receives a stop payment notice before all the loan funds are disbursed is obliged to withhold enough of the remaining funds to pay the claimant and then use those funds to pay him. CC

§§8536 and 8540. The contractor who properly stop-noticed the project may get paid despite the fact that its mechanics lien was destroyed by a construction loan foreclosure.

However, telling a lender that its priority is being taken away is like telling it that it has lost its collection rights—not news that any lender will easily accept. Construction lenders could be expected to follow similar stratagems that mortgage lenders have employed to escape the impact of debtor protection rules. The stop notice claimant's reach could be correspondingly limited by eliminating (or reducing) the loan funds that were available to be stopped. By transferring the loan balance from the lender's general account into a special segregated account and claiming that the loan had thereby already been disbursed, or by having the funds technically given to the borrower but then immediately pledged back and put into special accounts that would later be disbursed as progress payments, or by any similar accounting device, a construction lender could make all remaining loan funds disappear and thereby undo what the stop notice statute was attempting to accomplish. *(Round Three.)*

This naturally led to the statutory counterattack. Former CC §3166—the version applicable in *Brewer*—asserts: "No assignment by the owner or contractor of construction loan funds 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." The newer version, CC §8544, declares: "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 ... whether the assignment is made before or after the stop payment notice is given." Bookkeeping tricks are not supposed to prevent the stop notice claimant from reaching the funds.

The One-Two Punch of *Familian* and *Brewer*

Fifteen years ago, in *Familian v. Imperial Bank* (1989) 213 CA3d 681 (reported at 12 CEB RPLR 251 (Nov. 1989)), the Fourth District concluded that this statutory invalidation of an "assignment" also covered a lender's transfer of loan funds into preallocated accounts from which that lender would pay itself loan fees, document preparation fees, administrative expenses, and interest as those charges accrued. In light of the "before or after" language in the statute, that meant the stop notice claimant could not only reach the remaining funds in those accounts, but could also claw back what the lender had previously withdrawn.

Although the First District later disagreed with Familian's clawback conclusion (in *Steiny & Co. v. Citicorp Real Estate, Inc.* (review dismissed and cause remanded to court of appeal by supreme court July 11, 2001; ordered not published Sept. 12, 2001; superseded opinion at 72 CA4th 199)), the supreme court depublished that opinion, leaving *Familian* alone and unchallenged. Now, in *Brewer v. Point Ctr. Fin.*, that district has reasserted and even enlarged that doctrine. The stop notice claimant in *Brewer* was allowed to get to fees that the lender had not only paid to itself, but also money that it had paid to others in conjunction with making the loan—funds it claimed had been already earned before the stop notice arrived. (While technically dodging the issue for not having been properly raised below, the court also said that "labeling the disbursements lender received as earned versus unearned is of little consequence," which is a fairly good omen of how it would treat that issue if it ever comes up again.) This reachback also included funds paid to others for tax service and credit reports, as well as charges made under a separate loan and deed of trust on the property.

The court's rejection of a more "tailored" approach, which would have treated "earned" and "unearned" differently, did not surprise me, given that the history of mortgage law shows that whenever a distinction is made, lenders rewrite their documents to get on its good side—all disbursements would soon be labeled "earned preallocations." Superior equities—and I see this decision as giving contractors a superior equity over construction lenders—do not fare well if the other side can burden them down with distinctions.

Round Four?

Brewer takes *Familian* about as far as it can go. Only a supreme court holding or legislative rewriting would make the doctrine more authoritative or different. But do not forget that this is only half of the battle. Now it is the turn of the lenders, who cannot make the rules but can and do draft the documents to avoid or evade those rules. I do not expect construction lenders to accept their defeats happily, although it may take another 10 to 15 years to see what happens next.

***Brewer Corp. v. Point Ctr. Fin., Inc.* (2014) 223 CA4th 831**

This case involved the proper interpretation of several stop notice statutes intended to help enforce mechanics liens. Point Center Financial, Inc. (Lender), a licensed real estate broker, facilitated the raising of construction loan funds for a condominium project (the Project), subjecting it to the stop notice statutory scheme set forth in former CC §3087. As Lender raised funds for subsequent stages of construction, it assigned portions of its beneficial interest in the construction loan trust deed to third party investors. Under the private loan placement and fee agreements on each of these loans, Lender prepaid itself interest, points, loan underwriting, and other fees—totaling $1,555,771.37 (as used in the decision, the term "prepaid" meant that Lender was paid before the stop notice claimants were paid in full on their claims). Respondents Brady Company/San Diego, Inc. (Brady), Dynalectric Company (Dynalectric), Division 8, Inc. (Division 8), and Brewer Corporation (Brewer, collectively Respondents) are contractors who provided labor, services, equipment, and materials to the Project. In June 2007, Brewer served its bonded stop notice on Lender. At that time, although Lender was holding sufficient unexpended construction loan funds to cover the claim, it did not withhold the funds. When Lender received additional bonded stop notices from the other contractors, all construction loan funds held by it had already been disbursed.

Respondents filed individual actions against Lender, the owner, and others to recover the cost of their services and materials. The sole issue before the trial court was Lender's liability with respect to Respondents' bonded stop notice claims under former CC §3166, which prohibited assignments before or after receipt of a stop notice. Relying on *Familian Corp. v. Imperial Bank* (1989) 213 CA3d 681, reported at 12 CEB RPLR 251 (Nov. 1989), in interpreting §3166, the trial court determined that Respondents' stop notice claims took precedence over Lender's alleged contractual right to pay itself all interest, loan fees, and other preallocated expenses because "[l]enders cannot avoid a *section 3166* priority by private agreement." 213 CA3d at 686. The trial court also denied Lender's motions for entry of judgment against Dynalectric and Division 8 based on the alleged failure of these claimants to comply with former §§3097 and 3172. Lender appealed the judgment.

The court of appeal affirmed in part, reversed in part, and remanded. Lender contended that *Familian* was wrongly decided and should be rejected. Alternatively, it asserted *Familian* was distinguishable on the facts because Lender's disbursements to itself were not assignments. The trial court followed the *Familian* court's interpretation of the word "assignment" in rendering judgment for the stop notice claimants here. Reviewing the issue de novo, the court defined an assignment as a "transfer of rights or property." The agreement here permitted a transfer of rights over the construction loan funds from the borrower to Lender (to pay itself) and thus constituted an assignment within the meaning of §3166 and *Familian*. The court found that Lender's interpretation was contrary to the entire purpose of §3166, which was to supersede private arrangements of borrowers and lenders to ensure that construction loan funds are used to pay contractors' stop notice claims. Thus, the court affirmed, holding that *Familian* is not legally flawed and the trial court did not err in applying its holding to the facts of this case.

Lender also argued that even if the disbursements were assignments, it could not "withhold" funds within the meaning of former §§3159 and 3162 that had already been disbursed under the agreement. Again, the court noted that Lender's construction would defeat the purpose of the stop notice procedure by creating a loophole to §3166 for funds disbursed under a loan agreement. The legislature created the stop notice law to give laborers and materialmen priority over any "assignment" of the construction loan funds, whether the assignment is made before or after a stop notice is served. The court noted that former §3166 does not prohibit lenders from drafting agreements giving themselves a contractual right to priority; it simply assures that lenders' contractual priority cedes to stop notice claimants' statutory priority, allowing a judgment to be satisfied from funds it has already disbursed to itself under the agreement. Lender also made a host of arguments on why the amount of the award should be reduced, all of which were rejected by the court.

The court reversed the judgment as to Dynalectric, holding that its failure to serve a preliminary 20-day notice under former CC §3097 prevented it from recovering under its bonded stop notice, but remanded for further proceedings on a potentially dispositive factual issue of the existence of an excuse for not serving a preliminary notice on Lender. As to Division 8, which failed to serve Lender with a notice of the commencement of its stop notice action within 5 days after filing its complaint as required by former §3172, the court of appeal affirmed the trial court's ruling that Division 8 substantially complied and, even if it had not, that Lender was not prejudiced by Division 8's failure to serve the notice.