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Stop Notices Versus Preallocated Disbursements: Brewer v Point Center

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Stop Notices Versus Preallocated Disbursements

Roger Bernhardt

Brewer Corp. v Point Ctr. Fin.

The opinion in *Brewer Corp. v Point Ctr. Fin., Inc.* (2014) 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 to deny 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.

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