Commentary

California Courts Create Super-Priority Lien for Construction Site Improvers: Lenders Must Ensure That Site Improvement Contractors Are Paid

by Buchalter, Nemer, Fields & Younger

A California appellate court has imposed substantial responsibilities on construction lenders to ensure that the loan proceeds are used to pay potential mechanics' lien claimants who perform site improvements. [*Schmitt v. Tri-Counties Bank* 1999 Westlaw 163194 (Cal.App., March 26, 1999).] The opinion will probably increase the cost of construction lending.

Facts: A bank made a construction loan to a developer secured by a properly recorded deed of trust. Thirteen months later, the developer entered into an agreement with a contractor to perform site improvements.

The contractor performed its site improvements, but the contractor was not paid. The contractor recorded a notice of a mechanic's lien. After the developer defaulted, the bank foreclosed on the property. The contractor then asserted that its mechanic's lien took priority over the bank's trust deed under Civil Code 3137(c) notwithstanding that the lender's deed of trust was properly recorded more than thirteen months prior to the commencement of the site improvement work. Section 3137(c) states:

> [Mechanics' liens for site improvements] are preferred to...(c) any mortgage, deed of trust, or other encumbrance recorded before the commencement of the site improvement work which was given for the sole or primary purpose of financing such site improvements, *unless the loan proceeds are, in good faith, placed in the control of the lender under a binding agreement with the borrower to the effect that such proceeds are to be applied to the payment of claims of claimants* and that no portion of such proceeds will be paid to the borrower in the absence of satisfactory evidence that all such claims have been paid or that the time for recording claims of liens has expired and no such claims have been recorded. [Bracketed material and emphasis added.]

Site improvements are defined in Civil Code Section 3102 as follows:

"'Site Improvement' means the demolishing or removing of improvements, trees, or other vegetation located thereon, or drilling test holes or the grading, filling, or otherwise improving of any lot or tract of land or the street, highway, or sidewalk in front of or adjoining any lot or tract of land, or constructing or installing sewers or other public utilities therein, or constructing any areas, vaults, cellars, or rooms under said sidewalks or making any improvements thereon."

Holding: The trial court ruled in favor of the contractor, and the appellate court affirmed. The court first observed that in construing the statute, "any doubt about its meaning should be resolved in favor of the lien claimant." [Id. at 4.] The court then held that § 3137 requires the lender and the borrower to enter into a "binding agreement" to protect the mechanics' lien claimants. Here, although the construction loan agreement did require the borrower to supply conditional lien waivers, it did not expressly include provisions echoing the language of § 3137; "[A]bsent knowledge of section 3137 and reference to the substance of its key provisions, [the bank] has not shown it had a binding agreement within the meaning of the statute." [Id. at 5.]

The court went on, however, to hold that proper drafting would not have been enough to preserve the bank's priority; the bank was also required to control the proceeds until the liens were paid:

> [I]n order to preserve its priority under section 3137, [the bank] was required to do more that secure a binding agreement with reference to the borrower's obligations and hold the loan funds in good faith....*[T]he lender is required to control the loan proceeds until all the liens are paid.* [Id. at 5; emphasis and bracketed material added.]

The court reasoned that the language of the statute was subject to two different interpretations. The crucial phrase was the provision that the bank would be subordinated "unless the proceeds are, in good faith, placed in the control of the lender under a binding agreement with the borrower *to the effect* that such proceeds are to be applied to the payment of claims..." The bank argued that the phrase "to the effect" referred to the drafting of the agreement: the agreement had to provide language "to the effect" that the proceeds would be paid to the lien claimants. The court held, however, that the phrase "to the effect" meant "with the result" that lien claimants were actually paid.

The bank argued that the statute did not provide for a sanction in the event the lien claimants were not paid. The court disagreed:

> [W]e believe the Legislature intended loss of priority to be the sanction for a lender's failure to comply with section 3137. Indeed, fear of that loss provides an incentive for the lender to ask the borrower to provide a bond or maintain close control of disbursement of loan proceeds. [Id. at 6.]

The bank argued that the court's decision would require lenders to obtain bonds for site improvements, which would price owner/builders out of the loan market because they could not afford bonds. The court was unmoved by that argument:

> Lenders routinely assess the need to require payment and performance bonds in the course of processing construction loans. If a lender accepts the risk of loan funds for an undercapitalized or financially questionable project without requiring a bond, the lender, not the site improver, must bear any loss that results. [Id. at 6.]

COMMENT: Although the result in this case may come as a surprise to some construction lenders, it is entirely consistent with the recent trend of cases in this area: the mechanic's lien claimant almost always wins. The implications of the ruling are difficult to gauge.

Although the opinion interprets the priority provisions dealing with site improvements, California mechanics lien law is clear that if one claimant has priority over a deed of trust, all claimants doing work on the "work of improvement" share in the same priority. If a site improvement contractor on a work of improvement isn't paid, are all contractors elevated to the same super-priority position? The opinion is silent on the issue.

Although the opinion doesn't address the issue of title insurance, in all likelihood, the title insurance companies will take the position that there is no title insurance coverage since it was an "act of the insured" (failure to comply with statutory requirements in ensuring payment to site improvers) which resulted in the loss of priority.

Based on this court's expansive reading of the statute, it appears that construction lenders should take the following steps to prevent loss of priority:

1. The loan agreement must mention the statute and must expressly track the language of the statute.

2. The lender must set up procedures to make sure that potential lien claimants are paid directly out of the loan proceeds. Two-party checks, while cumbersome and difficult, will accomplish that result. Also, the lender must insist on final lien releases – and the expiration of all lien periods – before any retention sums are disbursed.

3. If the lender cannot ensure that all lien claimants will be paid in full, the lender must obtain a bond pursuant to Civil Code § 3139. The court in *Schmitt* recognized that those bonds will protect the lender from loss of priority. However, those bonds are not cheap, and the bonding agency will probably insist that the lender comply with § 3137.

This opinion may even have consequences beyond the area of lien property. The court apparently held that unless the lender ensures that the lien claimants are actually paid, the lender has (per se) failed to exercise good faith in the administration of the loan. It is possible that other parties, such as the developer, may attempt to assert derivative causes of action in tort for the lender's alleged lack of good faith. Although Civil Code § 3434 was designed to prevent lawsuits for "negligent loan administration" [typified by such cases as *Connor vs. Great Western Savings & Loan Assn.*, 69 Cal 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968),] the "good faith" holding in *Schmitt* might be viewed as an independent ground for such suits.

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