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Lender Alert
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Stop Notices and Mechanic's Liens: Construction Lenders' Nightmares

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I. Introduction

Historically low interest rates have led to the substantial growth in real estate lending, especially construction lending. Unfortunately, the lead article in the Business Section of the January 28, 2016, issue of the Los Angeles Time was "Fears of U.S. recession are growing." In addition, there has also been a noticeable increase in the numbers of complaints filed in the California Superior Court to enforce stop notices and to foreclose mechanics liens. Further, last year the title insurance industry achieved a very significant victory over a construction lender which had made a construction loan in the amount of $86 million, but was subordinate to $17 million in mechanic's liens. The title insurer avoided all liability to the construction lender for indemnity against the mechanic's liens on the basis that the construction lender had "created" or "suffered" the mechanic's liens because the construction lender had ". . . cutoff loan funds . . ." See, *B&B Syndication Services, Inc. v. First American Title Insurance Company* (7th Cir. 2015) 780 F.3d 825.

The purposes of this Lender Alert are to: (1) acquaint you with the increased risks construction lenders face with respect to stop notices and mechanic's liens; (2) familiarize you with the "gaps" in title insurance coverage created by Exclusions 3(a) and (b); and (3) provide you with some practical suggestions to reduce those risks.

II. Mechanic's Liens – The Silent Lien Which May Have Priority Over The Lender's Deed Of Trust

Mechanic's liens are frequently misunderstood. One of the most common misunderstandings is that a mechanic's lien does not attach to a parcel of property until after a mechanic's lien is formally recorded in the County Recorder's office. Not so. A mechanic's lien is a "silent" lien which attaches itself to a parcel of property as of the date of the "commencement of the work of improvement" or the delivery of construction materials to the property.

Before making a construction loan, a complete and accurate inspection of the property is required to determine whether there has been a "commencement of the work of improvement" or the delivery of materials to the property so that the lender can find out if mechanic's liens have been attached to the property. If the lender or any possible representative or agent of the lender, such as an appraiser, inspects the property and there was visible commencement of the work of improvement or delivery of materials to the property which was not disclosed in writing to the title insurer before the recordation of the Deed of Trust, then the lender should anticipate that the title insurer will attempt to deny coverage based on Exclusion From Coverage 3(b) for matters known to the insured, not recorded in the public records and not disclosed in writing to the insurer. If construction has commenced before the recordation of the Deed of Trust securing the construction loan, the lender should consider obtaining and recording a payment bond. If a mechanic's lien has already been recorded, a mechanic's lien release bond will clear title to the property, but the cost of the bond may be substantial. The lender, in its written instructions to the title company, should therefore advise the title company that there may have been a "commencement of the work of improvement" and instruct the title company that the escrow for the loan should not close unless the title insurer can record the construction Deed of Trust as a first lien on the borrower's property.

In addition, it is important for the construction lender, in its written escrow instructions, to expressly instruct the title company to record the construction Deed of Trust as a first lien on the borrower's property. Far too frequently, lenders only instruct the title company to record the construction Deed of Trust when the title company is prepared to issue a loan policy of title insurance which insures the construction Deed of Trust as a first lien on the property. It is the position of the title industry that an instruction similar to this is not an instruction which *actually* requires that the construction Deed of Trust be recorded as a first lien on the borrower's property. Rather, it is the title industry's position that it is merely an instruction which requests the issuance of a loan policy of title insurance which, subject to its terms and exclusions, will provide insurance benefits to the construction lender in the event that the construction Deed of Trust were not recorded as a first lien on the borrower's property.

It is important for the construction lender to remember that there are two separate and distinct aspects to the recordation of the construction Deed of Trust which must be the subject of its escrow instructions. First, it should be recorded as a first lien on the borrower's property. Second, the construction lender should be issued an ALTA loan policy which insures it against loss or damage in the event that the construction Deed of Trust were not recorded as a first lien on the borrower's property. These are two separate and distinct protections for the construction lender which may only be obtained with properly drafted instructions to the title company.

III. Stop Notices Which May Require The Lender To Refund Its Loan Fees And Interest Payments

A bonded stop notice can be much more damaging to the rights of the construction lender than a mechanic's lien. This is because a bonded stop notice may require the construction lender to refund to the person who provided labor and material to the property all of the loan fees and interest payments which were paid from the loan

funds. *Familian Corp. v. Imperial Bank* (1989) 213 Cal. App.3d 681 and *Brewer v. Point Center Financial, Inc*. (2014) 223 Cal. App.4th 831. The rights of the persons who provided labor and materials to the construction of the project to "claw back" loan fees and interest payments, which were already earned by the construction lender before the bonded stop notice is served on the construction lender, has been the subject of extensive and conflicting litigation in California. See, *Steiny & Co. v. Citicorp Real Estate, Inc.* (1999) 72 Cal. App.4th 199. A stop payment notice release bond in an amount of 125% of the amount claimed in the stop notice allows the disbursement of construction loan funds despite the receipt of a stop notice. However, until the Court of Appeal's decision in *Familian Corp. v. Imperial Bank* is changed, a construction lender must be very concerned about a bonded stop notice.

IV. Unsecured Loan Guaranties And Why They Are Of Dubious Value To The Lender

It is not uncommon for construction lenders to accept loan guaranties from a real estate borrower and its principals. Unfortunately, most of these loan guarantees are unsecured. Accordingly, when the borrower encounters financial difficulties, unsecured loan guaranties are frequently found to be worthless. Therefore, when making a construction loan, a prudent lender will require secured guaranties and frequent updates on the financials of its guarantors.

V. The Lender's Escrow Instructions Are The Key To Avoiding Loss Of Lien Priority

The construction lender's written escrow instructions to the title company are the key to obtaining a first priority Deed of Trust on the borrower's property. Proper written escrow instructions not only expressly instruct the title company to record the construction Deed of Trust as a first lien on the borrower's property, they also expressly instruct the title company to issue a loan policy of title insurance to protect the construction lender against loss or damage in the event that the construction Deed of Trust is not recorded as a first lien on the borrower's property. If the construction lender's escrow instructions to the title company require that the construction Deed of Trust be recorded as a first lien on the borrower's property, and that is not done, the construction lender may have a claim against the title company for breach of the escrow instructions and may be entitled to recover from the escrow agent all of its unpaid loan balance (since the title company will have disbursed the loan proceeds in violation of the express escrow instructions). See, *Ruth v. Lytton Savings and Loan Association of Northern California* (1968) 266 Cal. App. 2d 831, 838; *Old West Annuity and Life Ins. Co. v. Progressive Closing & Escrows, Inc*., (10th Cir. 2003) 74 F. Appx. 4, 5: and *Citicorp Savings of Illinois v. Stewart Title Guaranty Company* (7th Cir 1987) 840 F. 2d 526, 531. Accordingly, escrow claims may be more valuable to the construction lender than a claim on a loan policy of title insurance which contains terms and exclusions which are favorable to the insurer and unfavorable to the construction lender.

VI. The Title Insurer's Claims That If There Are Insufficient Loan Funds to Complete The Project There Is No Coverage

Since at least 1979, the title industry has claimed that if there are not sufficient loan funds to complete the construction of the project or if a construction lender terminates funding because of a borrower's default, that act "creates" or "suffers" the mechanic's liens which subsequently arise from the lack of loan funds, which then triggers the application of Exclusion 3(a) of the loan policy of title insurance. See, *Bankers Trust Co. v. Transamerica Title Insurance Co.* (10th Cir. 1979) 594 F.2d 231. However, construction lenders have had their own victories over title insurers on this issue starting in 1986 with the opinion in *American Savings & Loan Assn. v. Lawyers Title Insurance Corp.* (6th Cir. 1986) F.2d 780. Unfortunately, last year, the Seventh Circuit Court of Appeals issued its opinion in favor of First American Title Insurance Company in *B&B Syndication Services, Inc.*

First American Title Insurance Company was the title insurer for B&B Syndication Services, Inc., the construction lender for a large commercial development in Kansas City, Missouri, which failed in the middle of construction because of cost overruns when the developer would not cover the short fall and the construction lender stopped disbursing loan funds.

In *B&B Syndication Services, Inc.*, the borrower filed for bankruptcy protection and the Bankruptcy Court allowed $17,000,000.00 in mechanic's liens, all of which were given *priority over the construction lender's Deed of Trust*. The unfinished construction project yielded only $10,000,000.00 when sold at auction. All of the creditors eventually settled leaving the construction lender with a paltry $150,000.00 on its loan balance of $61,000,000.00.

It is noteworthy that the Court of Appeals makes reference to the difficult to obtain "Seattle Endorsement," which endorsement allows a lender to terminate funding and retain title insurance coverage. However, since B&B Syndication Services, Inc. did not have the "Seattle Endorsement," the Court of Appeals concluded that while the construction lender did have the contractual right with its borrower to terminate funding, this did not affect whether the construction lender ". . . owed a duty to its title insurer to supply sufficient funds to cover outstanding unpaid work." The Court of Appeals ultimately concluded that the construction lender had no title insurance coverage because its failure to provide sufficient loan funds had purportedly "created" or "suffered" the mechanic's liens which barred coverage under the loan policy of title insurance pursuant to Exclusion 3(a).

The Court of Appeals decision in *B&B Syndication Services, Inc*. may be explained by the mechanic's lien rules which are applicable in Missouri and approximately a dozen other states. However, this decision is a reminder to construction lenders of the significant limitations to the benefits provided by loan policies of title insurance and of the importance of requiring the title company to record the construction Deed of Trust as a first priority lien on the borrower's property.

VII. Conclusion

This Lender Alert is not intended to be a comprehensive analysis of the risks of stop notices and mechanic's liens to construction lenders. Rather, it is the purpose of this Lender Alert to outline to construction lenders certain risks presented by stop notices and mechanic's liens and provide some recommendations for ways to reduce those risks.

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