Stop Notices and Equitable Liens: A Revolution in Private Construction Work Remedies

By James E. Burden*

Several recent decisions involving statutory stop notices and common-law equitable liens are having a revolutionary impact on the construction and lending industries.

A subcontractor, laborer, or materialman who knows how to use the stop notice and equitable lien remedies may collect his bill in full with interest from an owner or a lending institution with whom he had no contractual relationship, while others, who failed to utilize either remedy, remain unpaid. The owner or lender, not aware of the dangers involved, may discover that he is required to pay the bills of these people with interest after making what he thought was full payment of his obligations.

Various important decisions over the past few years have resulted in the increased use of the stop notice and equitable lien remedies which, although established many years ago,¹ were seldom used until recently. This article will discuss these remedies and their application to private construction jobs. No attempt is made to discuss the use of the stop notice statute in relation to contracts of public work.

I

THE STOP NOTICE REMEDY

The stop notice remedy for private construction jobs is set forth in California Code of Civil Procedure, sections 1190.1 and 1197.1. The remedy allows certain unpaid subcontractors, laborers, and materialmen to serve a "stop notice," called also a "verified claim," and "notice to withhold," ²

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1 The stop notice statute was originally enacted in 1872 as CAL. CODE CIV. PROC. §1184. This statute, mainly concerned with jobs of public improvement, provided for service of the notice on the owner of the property. In 1951, Section 1184 was repealed, modified, and re-enacted as CAL. CODE CIV. PROC. §1190.1. The amendment added subdivisions (h)–(m), providing for the service of a stop notice on the lender, escrow agent or other third party holder of construction funds. The equitable lien remedy originated in 1928 in the case of Smith v. Anglo-California Trust Co., 205 Cal. 496, 271 Pac. 898.

2 These terms are used interchangeably in the wording of CAL. CODE CIV. PROC. §§1190.1, 1197.1.
on the holder of construction funds directing him to withhold the amount of the unpaid claim from the balance of the funds.

Although the stop notice remedy and the mechanics' lien remedy have certain procedural connections, the remedies are separate and distinct. The stop notice, in general, imposes a lien on the construction funds for a project, and the mechanics' lien imposes a lien on the real property upon which the claimant has provided labor or material. The right to pursue the stop notice remedy is not conditioned upon the filing of a mechanics' lien. The foreclosure of a deed of trust on the real property of the construction project has no effect on the rights of the stop notice claimant, although the foreclosure extinguishes the rights of the mechanics' lien claimant where the deed of trust is recorded prior to the commencement of the work.

Who Can Use the Stop Notice Remedy?

Any of those members of the construction industry mentioned in mechanics' lien sections 1181 and 1184.1, California Code of Civil Procedure, can use the stop notice remedy, except the contractor. The reference to the mechanics' lien code sections apparently incorporates the case law construing those sections to determine whether a particular party

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3 Cal. Code Civ. Proc. §1190.1(a), (c), (h).
5 Cal. Code Civ. Proc. §1190.1 (c), (h).
10 Mechanics, materialmen, contractors, subcontractors, artisans, architects, registered engineers, licensed land surveyors, machinists, builders, teamsters, and draymen, and all persons and laborers of every class performing labor upon or bestowing skill or other necessary services on, or furnishing materials to be used or consumed in, or furnishing appliances, teams, or power contributing to, the construction, alteration, addition to, or repair, either in whole or in part, of, any building, structure, or other work of improvement.
11 Any person who, at the instance or request of the owner (or any other person acting by his authority or under him, as contractor or otherwise) of any lot or tract of land, grades, fills in, or otherwise improves the same, or the street, highway, or sidewalk in front of or adjoining the same, or constructs or installs sewers or other public utilities therein, or constructs any areas or vaults, or cellars, or rooms, under said sidewalks, or makes any improvements in connection therewith.
is entitled to file a mechanics' lien. If the party is so entitled, he may utilize the stop notice remedy unless he is the prime contractor. Where a materialman or laborer contracts directly with the owner of the property to do a portion of the work, the materialman or laborer is considered a "subcontractor" and can use the stop notice remedy even though there is no intervening prime contractor.

**Form of the Notice**

The stop notice should contain the following information:

1. Notice to the holder of the construction funds that the claimant has furnished or has agreed to furnish labor or materials or both to the contractor or other person acting by the authority of the owner.
2. A general description of the kind of labor and materials furnished or to be furnished.
3. The name of the person to or for whom the above was furnished or is to be furnished.
4. The amount of the claim showing the value of the labor or materials already done or furnished, and if some work is not completed, the amount agreed to be done or furnished.
5. Verification by the claimant or someone acting in his behalf.

The form of the notice is the same whether the notice is served on the owner or on a third party holder of the funds. A defect in the form of the stop notice does not make it invalid as long as the notice is sufficient to advise the recipient of the information listed above.

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13 For example, a materialman furnishing materials to another materialman is not entitled to claim a mechanics' lien. Harris & Stunston, Inc., Ltd. v. Yorba Linda Citrus Ass'n. 135 Cal. App. 154, 26 P.2d 654 (1933). Apparently, such a materialman would be precluded from using the stop notice remedy. Cf., Theisen v. County of Los Angeles, 54 Cal.2d 170, 5 Cal.Rptr. 161, 352 P.2d 529 (1960) (involving stop notice on public work).
17 Ibid.
18 Ibid.
19 The amount of the claim can include interest from the date the obligation became due. See note 81 and accompanying text infra.
Should The Notice Be Accompanied By A Bond?

There is no necessity for a bond to accompany a stop notice that is served on the owner of the property holding construction funds. The owner is obligated under the statute to withhold funds in response to an unbonded stop notice.

Where the lender, escrow agent, or party other than the owner of the property holds the construction funds, he is under no statutory duty to withhold funds in response to a stop notice unless the notice is accompanied by a bond, although he may respond to the unbonded stop notice if he wishes. This voluntary response may be advisable since the unbonded stop notice recipient can become liable to the stop notice claimant under the common-law equitable lien theory, which is discussed later in this article. As far as the stop notice remedy is concerned, failure to furnish a bond for service of a stop notice on a party other than the owner will preclude the claimant from obtaining relief under the statute.

The amount of the necessary bond must equal one and one-fourth times the amount claimed in the stop notice. The bond assures the recipient that if the defendant recovers judgment in an action brought on the stop notice, the claimant will pay all costs that may be awarded against the owner, contractor, or other person withholding the funds, and all damages which the same may sustain by reason of the service of such notice, not exceeding one and one-fourth times the amount of the claim. If the bond is in the form of personal sureties, the person holding the funds has twenty (20) days after service of the notice to object, if he wishes, to the sufficiency of the sureties by a notice in writing to the claimant. The claimant must within ten (10) days after receipt of such written objection substitute another bond in the same amount executed by a corporate surety licensed to write such bonds in California or the recip-
When Is The Stop Notice Served?

A stop notice may be served any time after the execution of the contract in which the claimant has agreed to perform labor or furnish materials, but it must be served prior to the expiration of the period within which mechanics' liens must be filed. The following is a guide to determine the appropriate period:

<table>
<thead>
<tr>
<th>STATUS:</th>
<th>STOP NOTICE MUST BE SERVED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Job completed&lt;br&gt;Valid notice of completion recorded within 10 days after completion</td>
<td>Within 30 days after date of recording of notice of completion</td>
</tr>
<tr>
<td>2. Job completed&lt;br&gt;No valid notice of completion recorded</td>
<td>Within 90 days after completion of job</td>
</tr>
<tr>
<td>3. Job not completed&lt;br&gt;Valid notice of cessation recorded after cessation of labor for 30 days or more</td>
<td>Within 30 days after date of recording cessation of labor</td>
</tr>
<tr>
<td>4. Job not completed&lt;br&gt;Cessation of labor for 60 days&lt;br&gt;No notice of cessation recorded</td>
<td>Within 90 days after expiration of the 60-day period of cessation of labor</td>
</tr>
</tbody>
</table>

A notice of completion will only limit the period if it is properly prepared and is recorded within ten (10) days after actual completion. Likewise,

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34 Ibid.


38 Cal. Code Civ. Proc. §§1193.1 (f) states: "The notice of completion shall be filed in the office of the county recorder of the county in which the property is situated, shall be signed and verified by the owner or his agent and shall set forth the following: (1) the date of the completion of such work of improvement or of such particular portion of the work of improvement; provided, that the recital of an erroneous date of completion shall not affect the validity of the notice if the true date of completion is within 10 days preceding the date of filing for record such notice; (2) the name and address of such owner; (3) the nature of the interest or estate of such owner; (4) a description of the property sufficient for identification, which description shall contain the street address of such property if any such street address shall have been given to such property by any competent public or governmental authority; provided, that if a sufficient legal description of the property is
a notice of cessation of labor will limit the period only if it is properly prepared 41 and is recorded after a continuous period of cessation of labor for thirty (30) days or more. 42 These factors should be considered before concluding that a notice of cessation or completion has limited the time within which stop notices can be served. 43

How Is The Stop Notice Served?

The unbonded stop notice to the owner-holder of funds is served in one of the following manners:

(1) By delivering the notice to the owner personally; 44 
(2) By leaving it at the owner’s residence; 45 
(3) By leaving the notice at the owner’s place of business with some person in charge; 46 
(4) By delivering the notice to the owner’s architect; 47 
(5) By sending the notice to the owner by registered mail. 48 
(6) By sending the notice to the owner by certified mail. 49

given the validity of the notice shall not be affected by the fact that the street address recited is erroneous or that such street address is omitted; (5) the name of the original contractor, if any, for the work of improvement . . . and a general statement of the kind of work done or materials furnished pursuant to such contract.”

39 CAL. CODE CIV. PROC. §1193.1 (c) ; See also Doherty v. Carruthers, 171 Cal.App.2d 214, 340 P.2d 58 (1958) (Owner who recorded notice of completion 69 days after the completion was estopped from denying validity of mechanics’ lien filed 99 days after completion but 30 days from the date of filing of the invalid notice of completion.)

40 CAL. CODE CIV. PROC. §1193.1 (c) ; Munger v. McBratney 131 Cal.App.2d Supp. 866 (1955) (notice of completion filed before actual completion of work is ineffective).

41 CAL. CODE CIV. PROC. §1193.1 (h) states: “The notice of cessation . . . shall be filed for record in the office of the county recorder of the county in which the property is situated, shall be signed and verified by the owner or his agent and shall set forth the following: (1) the date on or about when the cessation from labor commenced; (2) a statement that such cessation continued until the giving of such notice of cessation; (3) the name and address of the owner; (4) the nature of the interest or estate of such owner; (5) a description of the property sufficient for identification, which description shall contain the street address of such property if any such street address shall have been given to such property by any competent public or governmental authority; provided that if a sufficient legal description of the property is given the validity of the notice shall not be affected by the fact that the street address recited is erroneous or that such street address is omitted; (6) the name of the original contractor, if any, for the work of improvement as a whole.”

42 CAL. CODE CIV. PROC. §1193.1 (c), (d), (3).


44 CAL. CODE CIV. PROC. §1190.1 (b).

45 Ibid.

46 Ibid.

47 Ibid.

48 CAL. CODE CIV. PROC. §1190.1 (l).

49 CAL. CODE CIV. PROC. §§11, 1190.1 (l).
The bonded stop notice to the holder of funds other than the owner is served in one of the following manners:

(1) By serving the notice personally on the holder of funds;\(^50\)
(2) By sending the notice by registered mail;\(^51\)
(3) By sending the notice by certified mail.\(^52\)

In order to obtain effective service on an institution\(^53\) maintaining branch offices, the stop notice should be served on the manager or other responsible officer or person at the office or branch maintaining the construction funds.\(^54\)

**Suit To Enforce The Stop Notice**

A suit to enforce the stop notice must be filed within ninety (90) days following expiration of the period within which mechanics' liens and stop notices must be filed\(^55\) or the stop notice ceases to have effect and any moneys withheld on account of it can be released.\(^56\) A suit commenced prior to the expiration of such period\(^57\) is subject to a plea in abatement\(^58\) that must be pleaded before the defect ceases to exist or it is waived.\(^59\)

It is important to point out the difference between the statutory time requirements for filing a suit to enforce a stop notice, discussed above, and the time requirements for filing a suit to enforce a mechanics' lien. A mechanics' lien must be perfected by filing a suit to enforce it within ninety (90) days after the date that the mechanics' lien was recorded.\(^60\) Where a claimant has utilized both the mechanics' lien and stop notice remedies, he may discover that the time requirements for filing suits do not overlap and he has to commence two actions to enforce each remedy separately.\(^61\)

Although an action to enforce a stop notice is commenced within the

\(^{50}\) Cal. Code Civ. Proc. §1190.1 (h).
\(^{53}\) Such as a banking corporation or association, building and loan association, title insurance company, or escrow holder.
\(^{55}\) See notes 37–43 and accompanying text, *supra*.
\(^{57}\) See notes 37–43, *supra*.
\(^{59}\) Miller v. Mountain View Sav. & Loan Ass'n., *supra* note 58.
\(^{61}\) Accord, Miller v. Mountain View Sav. & Loan Ass'n., 238 Cal.App.2d 644, 654, 38 Cal. Rptr. 78 (1965) (dictum; the suit, attempting to enforce both the stop notice and mechanics' lien, was premature for a stop notice action and timely for a mechanics' lien action).
proper time, the action may be dismissed by the court if it is not brought to trial within two years after its commencement.\textsuperscript{62}

\textit{Five Day Notice Of Commencement Of Proceedings}

A notice of the commencement of the action to enforce the stop notice should be served on each stop notice recipient in the same manner as the stop notice was served within \textit{five} (5) days from the date of the filing of the action.\textsuperscript{63}

One writer\textsuperscript{64} has suggested \textsuperscript{65} that personal service of the summons and complaint on the lending institution, if served within five (5) days of the filing of the action, will fulfill this requirement. This suggestion would be consistent with the holding in \textit{Sunlight Electric Supply Co. v. McKee}\textsuperscript{66} where the court stated:\textsuperscript{67}

\begin{quote}
Unless some detriment can be shown to have resulted to the complaining litigant from a failure to file the notice of pendency within the five (5) days as outlined in the Code of Civil Procedure, Section 1197.1, subdivision (b), the requirement is not mandatory but merely directory and does not result in a divestiture of jurisdiction.\textsuperscript{68}
\end{quote}

\textit{Duty Of The Stop Notice Recipient}

The owner-holder of funds, upon receipt of an unbonded stop notice, must withhold from the money due or that may become due to his contractor or any other person an amount sufficient to answer the stop notice.\textsuperscript{69} This money must be withheld even though the owner is not obligated to advance further moneys to his contractor.\textsuperscript{70}

The \textit{A-1 Door} case\textsuperscript{71} describes the duty that is imposed by a bonded

\begin{itemize}
\item \textsuperscript{62} Cal. Code Civ. Proc. §1197.1 (a).
\item \textsuperscript{63} Cal. Code Civ. Proc. §1197.1 (b).
\item \textsuperscript{64} Dimitri K. Ilyin, \textit{Stop Notice!—Construction Loan Officer's Nightmare}, 16 Hastings L.J. 187 (1965).
\item \textsuperscript{65} Id. at 190.
\item \textsuperscript{66} 226 Cal.App.2d 47, 37 Cal.Rptr. 782 (1964). (Although the case concerns a stop notice filed with a public agency under Cal. Code Civ. Proc. §1190.1, the requirement of the notice of the commencement of proceedings applies equally to private and public jobs.)
\item \textsuperscript{67} Id. at 51.
\item \textsuperscript{68} A notice of commencement of proceedings was served in the \textit{Sunlight} case, supra notes 66 and 67, fourteen days after the action was filed, and there was no showing that the delay adversely affected the rights of the service.
\item \textsuperscript{69} Cal. Code Civ. Proc. §1190.1 (c).
\item \textsuperscript{70} See Diamond Match Co. v. Silberstein, 165 Cal. 282, 131 Pac. 874 (1913); Stettin v. Wilson 175 Cal. 423, 166 Pac. 6 (1917); both cases involve stop notices served on an owner pursuant to Cal. Code Civ. Proc. §1184, predecessor to present Cal. Code Civ. Proc. §1190.1.
\item \textsuperscript{71} A-1 Door and Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n., 61 Cal.2d 728, 30 Cal.Rptr. 85, 394 P.2d 829 (1964).
\end{itemize}
stop notice on a lender, escrow agent, or other third party holder of construction funds, as follows:

Subsection (h) requires that upon receipt of a bonded stop notice claim the fundholder 'must withhold from the borrower or other person to whom said owner may be obligated to make payments or advancements out of said fund sufficient money to answer such claim.' The subsection does not require the fundholder to withhold only so much of the fund as may be due under its contract with the owner. On the contrary the 'said fund' from which a lender must withhold claimed money is defined in the first paragraph of subsection (h) as that amount 'furnished or to be furnished by the ... lender ... as a fund from which to pay construction costs,' or that amount 'arising out of a construction or building loan.' The fundholder must therefore withhold from funds furnished to pay construction costs or arising out of a construction loan sufficient money to answer bonded stop notice claims regardless of the terms of its contract with the owner.72

The duty to withhold funds in response to a bonded stop notice is mandatory and supercedes any agreement or arrangement existing between the borrower and the lender.73 For example, the lender must respond to a stop notice served on him in all of the following situations:

1. After default of the borrower, the agreement calls for no additional progress payments and allows the loan balance to be credited against the indebtedness;74
2. The agreement allows the lender to use all or any part of the unused funds to further the construction of improvements as it deems best;75
3. The borrower assigns the funds to the lender as additional security for the loan and the stop notice is served after the lender, pursuant to the agreement, has charged back the remaining balance of the funds, crediting them to the amount of the indebtedness.76

The stop notices prevail in such situations because the last sentence of California Code of Civil Procedure, section 1190.1 (h) states:

No assignment by the owner or contractor of construction loan funds, whether made before a verified claim is filed or after such claim is filed shall be held to take priority over a claim filed under this subsection (h) and such assignment shall have no binding force insofar as the rights of claimants who file claims herein are concerned.

72 Id. at 734.
73 E.g., Ibid.
76 See CAL. CODE CIV. PROC. §1190.1 (h), (last sentence); Cf. Miller v. Mountain View Sav. & Loan Ass'n., 238 Cal.App.2d 644, 38 Cal. Rptr. 78 (1965) (dictum).
Since the effectiveness of the stop notice remedy does not depend upon there being actual construction "funds" in existence under the terms of the contract, it is not technically correct to characterize the stop notice as affecting an "equitable garnishment." 77

**Personal Liability of the Stop Notice Recipient**

If the owner-holder of funds ignores the stop notice and does not withhold sufficient funds to answer it, the owner becomes personally liable to the stop notice claimant 78 even though no such personal liability existed prior to the stop notice. 79

The lender, escrow agent, or other third party fund-holder, likewise, becomes personally liable to the stop notice claimant if he ignores the service of a bonded stop notice and fails to withhold funds in response to it. 80

**Interest on the Obligation**

The stop notice claimant can recover interest on his unpaid claim from the date that his obligation became due. 81 In the *A-1 Door* case 82 the court states:

> Nor is there any merit in defendant's contention that awarding interest before judgment will create unreasonable uncertainty for fundholders as to how much of the loan funds must be withheld when bonded stop notices are filed. The fundholder must withhold the amount claimed in the stop notice, and any doubts about how much to withhold can be resolved.

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79 An owner is ordinarily not personally liable to an improver with whom he has not contracted directly, and the same is true even though the improver imposes a mechanics' lien of his property. E.g., Golden Gate Bldg. Materials Co. v. Fireman, 205 Cal. 174, 270 Pac. 214 (1928).


81 Cal. Civ. Code §3287; A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n., 61 Cal.2d 728, 737, 40 Cal.Rptr. 85, 394 P.2d 829 (1964); Calhoun v. Huntington Park Sav. & Loan Ass'n., 186 Cal.App.2d 451, 462-463, 9 Cal.Rptr. 755 (1960) (dictum, since the claimant asked for interest from the date the stop notices were served and the court limited him accordingly).

82 A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n., supra note 81.
by examining the bond accompanying the notice. To compel the withholding of funds the claimant must file a bond in the amount of one and one quarter times the amount of the claim. The amount that must be withheld is therefore eighty per cent of the amount of the bond.\textsuperscript{88}

There is no indication in the opinion whether the claimants included a claim for interest in their stop notices and bonds. It is, therefore, unclear\textsuperscript{84} whether a stop notice claimant must claim interest from the due date in his stop notice claim in order to be granted interest from such date. Based on the language quoted above, it might be advisable to claim interest as part of the stop notice claim, bonding the notice in an amount equal to one and one-fourth times the amount of the principal obligation plus interest to the date of the notice. Failure to ask for interest from the date that the obligation became due or failure to prove such date at the trial will result in limiting the award of interest to that amount which has accrued since the date the stop notices were served.\textsuperscript{85}

\textit{Distribution of the Funds}

After the lien period has expired,\textsuperscript{86} those claimants who have properly complied with the stop notice statute\textsuperscript{87} can share pro rata in the remaining funds. California Code of Civil Procedure, section 1190.1 (d) states:

\begin{quote}
In the event the moneys so withheld or required to be withheld shall be insufficient to pay in full the valid demands of all persons by whom such notices were given, the same shall be distributed among such persons in the same ratio that their respective claims bear to the aggregate of such valid demands. Such pro rata distribution of said moneys shall be made among the persons entitled to share therein, without regard to the order of priority in which their respective notices may have been given or their respective actions, if any, commenced.
\end{quote}

The amount of each claim used as the basis for the proration equals the principal amount of the claim plus interest from the date the obligation became due, if properly claimed and proved, or if not, interest from the date of the service of the stop notice.\textsuperscript{88} The liability of the third party

\textsuperscript{88} \textit{Id.} at 737.

\textsuperscript{84} See authorities cited note 81 \textit{supra}; see generally Note, 12 U.C.L.A. L. Rev. 1246, 1250-51.


\textsuperscript{86} See text accompanying notes 37-43 \textit{supra}.

\textsuperscript{87} After 90 days has elapsed from the expiration of the lien period, only those stop notice claimants who have filed actions to enforce their stop notices have "properly complied with the stop notice statute;" see note 56 \textit{supra}.

\textsuperscript{88} See authorities cited note 81 \textit{supra}. 
fundholder distributing the funds is limited, if he has properly honored the stop notices, to the extent of the balance of the remaining construction loan funds.\footnote{89 A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n., 61 Cal.2d 738, 735-738, 40 Cal.Rptr. 85, 394 P.2d 829 (1964).}

If one or more claimants have filed suits to enforce their stop notice claims, their separate actions can be consolidated into a single action to determine the respective rights of the claimants.\footnote{90 Cal. Code Civ. Proc. §1197.1 (c)} The owner can demand that those claiming an interest in funds withheld by him join in one action to determine the respective rights of the parties to the funds.\footnote{91 Cal. Code Civ. Proc. §1197.1 (d).} The third party fundholder can have the respective rights of the claimants adjudicated by means of an action in interpleader\footnote{92 Cal. Code Civ. Proc. §386.} or by an action for declaratory relief.\footnote{93 Cal. Code Civ. Proc. §1060.} The interpleader action is preferable from the standpoint of the fundholder since costs and attorney fees can be awarded to him payable out of the funds.\footnote{94 Cal. Code Civ. Proc. §386.6.}

**Protection from the Stop Notice**

The lender and the owner may protect themselves from unnecessary stop notice liability by considering the following:

1. **LABOR AND MATERIAL BOND:**

   The lender or owner can insist that a statutory labor and material bond be furnished in compliance with California Code of Civil Procedure, section 1185.1.\footnote{95 See Cal. Code Civ. Proc. §1190.1 (c), (j).} The amount of the bond is not less than 50% of the contract price in the original contract.\footnote{96 Cal. Code Civ. Proc. §1190.1.} If the bond and the original contract are recorded in the office of the county recorder where the property is situated prior to the filing of the first stop notice,\footnote{97 If the contract and bond are recorded prior to the commencement of work, Cal. Code Civ. Proc. §1185.1 will protect the real property from mechanics' liens.} the recipient of a subsequent stop notice is under no statutory obligation to withhold funds in response to the notice.\footnote{98 See Cal. Code Civ. Proc. §§1185.1, 1190.1 (c), (j).}

2. **WRITTEN DEMAND OF THE OWNER:**

   The owner can demand in writing that all potential stop notice claimants serve stop notices on him within a reasonable time after the demand
and any such potential claimants who refuse to do so are deprived of the right to later utilize either the stop notice or the mechanics' lien remedy. 99

(3) FALSE NOTICE BY CLAIMANT:

If the claimant willfully gives false notice of his claim to the owner or includes in the claim work or materials not performed or furnished, the claimant forfeits his rights to participate in the distribution of construction funds. 100

(4) BUILDING LOAN CONTROL SYSTEM:

The lender can develop and maintain a tight building loan control system which will distribute funds only when the lender has received labor or material releases from potential stop notice claimants. 101

A recent decision 102 recognizes the doctrine of estoppel as it relates to the disbursement of progress payments pursuant to a building control system. The unpaid supplier of labor and materials signed a material and labor release in blank and gave it to the contractor to present to the savings and loan association to obtain supplier's progress payment which, pursuant to agreement, was paid to the contractor directly. The court held that the supplier was estopped from enforcing his stop notice filed after the contractor disappeared with the progress payment. 103 The case should give lenders hope that they can design a building loan control system that will give them protection.

(5) ACTION IN INTERPLEADER OR DECLARATORY RELIEF:

The only other protective device 104 available to the owner and lender is to deposit the funds in court and join all persons claiming an interest in the funds in one action in interpleader. 105 The action should include the

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103 Ibid.

104 The code specifies a summary procedure to determine the validity of disputed stop notices by affidavit, counter-affidavit, and a declaratory relief action. This procedure in Cal. Code Civ. Proc. §1190.1 (c) is apparently confined to stop notices on public jobs, since the code provides for service of the affidavit only on the "department head, board, commission, or officer thereof." Another device, Cal. Code Civ. Proc. §1191.1, specifies a procedure to file a release bond to obtain release of withheld funds. The wording of this section also seems to limit its application to stop notices on public jobs.

mechanics' lien claimants, since they may be able to assert an equitable lien on the construction funds. The rights of the interested parties can also be adjudicated in a declaratory relief action, although costs and attorney fees can be awarded the fundholder in the statutory interpleader action.

Failure to Comply with the Stop Notice Statute

Failure on the part of claimant to comply with the requirements of the stop notice or mechanics' lien statute will not affect his rights, in a proper case, to utilize another distinct remedy that will enable him to reach the remaining construction funds by imposing upon them a common-law equitable lien.

II

COMMON-LAW EQUITABLE LIEN ON CONSTRUCTION FUNDS

"A supplier of labor or materials can impose an equitable lien on the remaining construction funds if he can establish that either the borrower or the lender induced him to supply labor or materials in reliance upon being paid out of the construction funds. This common-law doctrine was originated in California many years ago and has been seldom used until recently when several decisions clarified, explained, and perhaps, expanded the application of the equitable lien.

The underlying theory for the doctrine is unjust enrichment; to wit: it would be unjust and inequitable to withhold the construction loan funds from those persons who have been induced to supply labor or materials in reliance upon receiving payment from the funds and whose work has enhanced the value of the property.

Requisites for Imposing an Equitable Lien

(1) Recording a Mechanics' Lien:

It is generally contended that the recording of a mechanics' lien is a

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106 See text of article re equitable liens infra.
112 McBain v. Santa Clara Sav. & Loan Ass'n, supra note 111, at 836.
condition precedent to the assertion of an equitable lien.\textsuperscript{113} The basis for this contention apparently comes from language in the case which originated the doctrine. In \textit{Smith v. Anglo-California Trust Co.},\textsuperscript{114} the court stated:

The court below should have, in our opinion, ordered and directed the securities company to pay this amount into court, to be thereafter disbursed, pro rata, among those persons having legally and satisfactorily established their lien claims against the parcels of real property . . . .\textsuperscript{115}

In \textit{Hayward Lumber \& Investment Co. v. Coast Federal Savings \& Loan Assn.},\textsuperscript{116} certain parties had filed claims of mechanics' liens but did not file suits to enforce them within the time required by the code.\textsuperscript{117} In considering whether their failure to perfect their mechanics' liens under the statute should preclude them from imposing an equitable lien on the unpaid construction fund, the court noted that the mechanics' lien remedy is statutory and the imposition of an equitable lien is based on equitable considerations. The court affirmed the trial court's judgment allowing the claimants to share in the distribution of funds.\textsuperscript{118}

The court in the \textit{A-1 Door} case,\textsuperscript{119} in its dictum, states that an equitable lien can be imposed where the borrower or the lender has induced "... the supplier of labor or materials to rely on the fund for payment."\textsuperscript{120} (Emphasis added.)

It is unclear\textsuperscript{121} whether a supplier of labor or materials, by establishing the necessary inducement and reliance upon the fund, could impose a lien on the construction funds without previously recording a claim of lien under the mechanics' lien statute.

On the other hand, where a claimant has recorded a claim of mechanics' lien, he is not entitled to impose an equitable lien because of this fact alone.\textsuperscript{122}

\begin{itemize}
  \item \textsuperscript{113} Miller v. Mountain View Sav. \& Loan Ass'n., 238 Cal.App.2d 644, 665, 48 Cal.Rptr. 278 (1965) (dictum).
  \item \textsuperscript{114} 205 Cal. 496, 271 Pac. 898 (1928).
  \item \textsuperscript{115} Id. at 504.
  \item \textsuperscript{116} 47 Cal.App.2d 211, 117 P.2d 682 (1941).
  \item \textsuperscript{117} Cal. Code Civ. Proc. §1190, then in effect, required a suit to be filed within 60 days of recording, unless a credit was given; this section was repealed in 1951 and reenacted the same year as Cal. Code Civ. Proc. §1198.1.
  \item \textsuperscript{118} Hayward Lumber \& Investment Co. v. Coast Federal Sav. \& Loan Ass'n., 205 Cal. 496, 271 Pac. 898 (1928).
  \item \textsuperscript{119} A-1 Door \& Materials Co. v. Fresno Guarantee Sav. \& Loan Ass'n., 61 Cal.2d 728, 40 Cal.Rptr. 85, 395 P.2d 829 (1964).
  \item \textsuperscript{120} Id. at 732.
  \item \textsuperscript{121} See authorities cited notes 113, 114, 116 supra; Pacific Ready Cut Homes, Inc. v. Title Ins. \& Trust Co., 216 Cal. 447, 14 P.2d 510 (1932).
  \item \textsuperscript{122} A-1 Door \& Materials Co. v. Fresno Guarantee Sav. \& Loan Ass'n., 61 Cal.2d 728, 732, 40 Cal.Rptr. 85, 395 P.2d 829 (1964).
\end{itemize}
(2) Inducement and Reliance:

In order to impose an equitable lien on unpaid construction loan funds, it must be established that either the borrower or the lender induced the supplier of labor or materials to rely on the fund for payment.\(^{123}\) In the recent *McBain* case,\(^{124}\) two subcontractors were told by the owner-borrower that they would be paid from a construction loan, although neither of them had actual knowledge of the identity of the lender.\(^{125}\) The court concluded:

If the inducement to the (claimants) is thus predicted upon the conduct of the borrower, it would seem immaterial that (the claimants) lacked actual knowledge of the identity of the lender . . . . The main consideration is that (they) were induced by the borrower to rely on the loan fund for payment.\(^{126}\)

An analysis of the evidence presented in the *McBain* case\(^ {127}\) shows that the reliance element is not difficult to establish if the claimant was aware of the construction fund prior to the furnishing of labor or materials.

*Effect of the Agreement Between Borrower and Lender*

Just as in the case of the statutory bonded stop notice,\(^ {128}\) it is not necessary to have "funds" due under the terms of the loan agreement in order to establish an equitable lien. In the *Miller* case\(^ {129}\) the savings and loan association, upon discovering that the work had ceased, charged back pursuant to the loan agreement each of the construction loan accounts with the unexpended loan funds and recorded notices of default under the deeds of trust. There were no "construction funds" in the construction fund accounts when, thereafter, an unbonded stop notice was served on the association, a claim of mechanics' lien was recorded, and the law suit was


\(^{124}\) *Ibid.*

\(^{125}\) One claimant knew from a conversation with the owner that the owner was getting a substantial payment and that he was to be paid from it. The claimant did not know what a construction loan fund was at that time, who it was from or the amount of the loan. Another claimant testified that the owner said that the claimant was to be paid for his services "75% out of the first progress payment" and the balance on the fourth progress payment.


\(^{127}\) *Id.* at 837-840; see also note 125 *supra*.

\(^{128}\) See notes 71-77 and accompanying text *supra*.

filed. The court held\textsuperscript{130} that these factors did not affect the imposition of an equitable lien on the funds. The court added:

Where the lender has received the benefit of the claimant's performance and therefore a more valuable security for its note, it is not justified in withholding or appropriating to any other use money originally intended to be used to pay for such performance and relied upon by claimant in rendering its performance.\textsuperscript{131}

\textit{The Effect of an Equitable Lien}

Where it can be shown that those supplying labor or materials to the property have been induced by either the borrower or the lender to rely on the construction loan funds for payment, their equitable lien on the funds will have priority over the claims of both the borrower and the lender.\textsuperscript{132} Where certain claimants have filed statutory stop notices under California Code of Civil Procedure, section 1190.1 and others have successfully asserted equitable liens on the remaining funds, it is unclear\textsuperscript{133} whether all would share pro rata in the remaining funds or whether one could claim priority over the other, to the extent that funds are available.\textsuperscript{134}

Just as in the case of bonded stop notices,\textsuperscript{135} the liability of the fund holder for the imposition of equitable liens is limited to the extent of the remaining loan funds.\textsuperscript{136}

III

CONCLUSION

The stop notice statute gives members of the construction industry an effective remedy to collect their unpaid bills even though the deed of trust on the property has been foreclosed,\textsuperscript{137} the owner or contractor cannot be

\textsuperscript{130} \textit{Ibid.}
\textsuperscript{131} \textit{Id.} at 661.
\textsuperscript{134} In H. O. Bragg Roofing, Inc. v. First Federal Sav. & Loan Ass'n. \textit{supra} note 133, an unbonded stop notice shared in the remaining funds on the same basis as two bonded stop notices. The right of the unbonded stop claimant was based on estoppel of the lender, a theory slightly different from the equitable lien theory.
\textsuperscript{135} See citation note 89 \textit{supra.}
\textsuperscript{137} See citation note 8 \textit{supra.}
located, or either of them has gone into a bankruptcy proceeding. The statutory obligations on the part of the lender and borrower have been fairly well defined by the decisions we have discussed. The effectiveness of the statute surprised many lenders who felt that after abandonment of the project they could contract to retain the unused construction funds to credit them against the loan or complete construction of the project.

The real surprise for lenders is the relationship of the equitable lien doctrine to the statutory stop notice and mechanics' lien remedies. If the claimant can establish the somewhat nebulous requirement of reliance on the fund, he can accomplish a similar result to the one provided for in the stop notice statute, even though his stop notice does not comply with the statutory requirements and his statutory mechanics' lien rights have been nullified by failure to file a suit to enforce them within the required time or by foreclosure of a deed of trust. Lenders can no longer afford to ignore unbonded stop notices, since they have no way of knowing whether the borrower induced the claimant to rely on the fund for payment thus giving the notice as much effectiveness as if it were bonded.

The result of all this is a revolution in the construction industry that subcontractors, laborers, and materialmen enjoy and borrowers and lenders despise. Members of the construction industry can be almost assured of collecting something if they pursue, where possible, all three remedies—mechanics' lien, statutory stop notice, and equitable lien.

We conclude with a caveat: Watch for legislation that will cause a counter-revolution.

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138 The owner of the property should be joined in a suit to enforce a bonded stop notice where it is possible and practicable, since he is a "necessary party" within Cal. Code Civ. Proc. §389. The owner is not an "indispensable party," thus where it is impossible or impracticable to join him, the court has jurisdiction to enforce the bonded stop notice without him. See Rossmian Mill & Lumber Co., Ltd. v. Fullerton Sav. & Loan Ass'n., 221 Cal.App.2d 705, 711, 84 Cal.Rptr. 644 (1963); A-1 Door & Materials Co. v. Fresno Guarantee Sav. & Loan Ass'n., 61 Cal.2d 728, 736 n.3, 40 Cal.Rptr. 85, 394 P.2d 829 (1964) (dictum); Cal. Code Civ. Proc. §389; See generally Bank of California v. Superior Court, 16 Cal.2d 516, 106 P.2d 879 (1940).


140 See authorities cited notes 73-76 supra.

141 See authorities cited note 111 supra.

142 See note 116 supra.

143 See authorities cited note 111 supra.

144 See note 109 supra.

145 See text accompanying note 113 supra.