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LIEN-TOS: HALF-FINISHED BUILDINGS AND
THE PRIORITY OF CONSTRUCTION LIENS

Gene Berk*

[If a man were in a mood to be sensual, he would be
aroused by the Mechanics' Liens Acts.]

I. INTRODUCTION

A. Mechanics' Liens

Unlike the legal remedies afforded butchers, bakers and
silicon chip makers, the California Constitution grants "mech-
nanics, materialmen, artisans, and laborers of every class" a
lien on real property to secure the payment of the price or
value of work performed and materials furnished that improve
such property. Why mechanics and materialmen have been

* Partner, Hunter McCray Richey & Brewer, Sacramento, California.
1. Charles E. Goulden et al., Comment, California Mechanics' Liens, 51 CAL.
   L. REV. 331 (1963) (quoting the late Justice Curtis Bok of the Pennsylvania Su-
   preme Court, "while discussing the unnecessary pother raised by bluenoses about
   sex in literature." Love in Fine Paragraphs, TIME, Oct. 19, 1962, at 96 (reviewing
   CURTIS BOK, MARIA (1962)).
2. Mechanic is not used in its more modern sense of a machinist, but is
   used in its older sense of a laborer, workman or artisan. See WEBSTER'S NINTH
3. CAL. CONST. art. XX, § 15. The mechanics' lien is entirely an American
   statutory innovation. The English common law never recognized a separate and
   special mechanics' lien and does not recognize such a lien today. Charles E.
4. For purposes of this article, unless the context clearly requires otherwise,
   "mechanics" shall refer to both (1) persons who provide materials and supplies,
   and (2) all laborers, whether skilled or unskilled, tradesmen, construction con-
   tractors and subcontractors, whether or not such persons also provide materials
   and supplies. "Materialmen" shall refer to those persons who only provide mate-
   rials and supplies. Although construction contractors and subcontractors have no
   constitutional right to a mechanics' lien, the legislature has included them within
   the class of mechanics. CAL. GIV. CODE § 3110 (West Supp. 1991).
singled out for special priority is now only of historical interest, but the morass of statutes that make up today's mechanics' lien laws are of ever growing importance to construction lenders and their title insurers.

The mechanics' lien laws bear scars from the continual negotiation undertaken to satisfy the competing and incompatible interests of owners, lenders, prime contractors, subcontractors, mechanics, materialmen, laborers, bonding companies, and title insurance companies. This statutory scheme is not only unnecessarily complex and inconsistent, but has the potential to harm the interests purportedly being advanced.

B. Half-Finished Buildings

Consider, for example, the construction of a commercial or residential building. If all goes well the mechanics are paid

5. As one delegate to the California Constitutional Convention noted: At every session, the mechanics of San Francisco send a man here for the purpose of getting the lien law in good position; the result has been confusion worse confounded all the time. This whole thing is infirm in principle; they want to make the man who is going to build a house, the insurer for the fulfillment of a contract with a third person.

3 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA 1417 (1881) (remarks of Delegate Shafter). Another delegate remarked:

I understand why the workman should be a preferred creditor, but I don't understand why the lumberman should be a preferred creditor. There has been no good reason urged here why he should stand on any better ground than any other creditor. Certainly lumber dealers are capable of looking out for their own interests. If they are not satisfied as to the solvency of the creditor then let them get security.

1Id. at 1394 (remarks of Delegate Dudley).

6. See CAL. CIV. CODE §§ 3082-3154 (West Supp. 1991); cf. Spinney v. Griffith, 32 P. 974, 975 (Cal. 1893) ("constitution in this respect is not self-executing"); Royston Co. v. Darling, 154 P. 15, 23 (Cal. 1915) ("this confused and confusing statute"); John J. Hopkins, Selected Mechanics' Lien Priority Problems, 16 HAST. L.J. 155 (1964) ("Even counsel for construction lenders, builders, materialmen, title insurers, and others who are confronted daily with problems in this area, frequently battle the uncertainties and ambiguities in the [mechanics' lien] law.").

7. "[L]osses due to mechanic's liens have historically been among the highest categories of loss experience of title insurance companies and in recent years have been the highest loss experience category." Henry O'Connor, Jr., Mechanic's Lien Coverage: Have the Policy Changes Changed the Coverage?, in TITLE INSURANCE: THE NEW POLICY CHANGES 145, 149 (1987).

on a timely basis and the proceeds from a sale or refinancing are used to pay off the real estate lender.

But what if the borrower/developer runs into problems during construction and breaches one or more of the provisions of the loan agreement. The borrower might have failed to keep the property free of liens, permitted unapproved modifications to the plans and specifications, allowed unauthorized delays in completion, or suffered budget overages. The lender is confronted with a half-finished building as security for its loan, a defaulting borrower, and unpaid mechanics with constitutionally-based liens on the property. The lender must decide between two alternatives: (1) cease advancing funds the moment any such default occurs and foreclose, thereby wiping out all junior liens (including mechanics' liens); or (2) advance additional funds to complete construction, permit the sale of the real property and now-completed improvements, and use the proceeds to pay off the construction lender, junior lenders, and mechanics' lien claimants.

As analyzed in detail below, the statutes regulating the priority of mechanics' liens encourage construction lenders to foreclose and wipe out all junior liens (including mechanics' liens), rather than advance additional funds to complete construction of a building that can be sold or refinanced in order to pay off all interested parties. What use is a constitutional grant of lien to mechanics if the legislation regarding mechanics' lien priority results in the speedy and unnecessary obliteration of all mechanics' liens at the first sign of a troubled construction project?

C. Civil Code Section 3136

The result described above flows from the practical effects
of a little cited and widely misunderstood amendment to the mechanics' lien laws now codified at California Civil Code section 3136 (hereinafter referred to as "section 3136"):

A mortgage or deed of trust which would be prior to the liens provided for in this chapter to the extent of obligatory advances made thereunder in accordance with the commitment of the lender shall also be prior to the liens provided for in this chapter as to any other advances, secured by such mortgage or deed of trust, which are used in payment of any claim of lien which is recorded at the date or dates of such other advances and thereafter in payment of costs of the work of improvement. Such priority shall not, however, exceed the original obligatory commitment of the lender as shown in such mortgage or deed of trust.

9. The only reported case in the past decade citing Civil Code § 3136 corrects a petitioner who apparently believed that the second paragraph of former Code of Civil Procedure § 1188.1 had been repealed rather than reenacted as Civil Code § 3136. Coast Cent. Credit Union v. Superior Court, 257 Cal. Rptr. 468 (Ct. App. 1989).

10. See infra note 12.

11. Although by its terms § 3136 applies only to the question of priority between mechanics' liens and first deeds of trust, one appellate court has expanded the scope of § 3136 to apply to lien priority between first deeds of trust and second deeds of trust. Turner v. Lytton Sav. & Loan Ass'n, 51 Cal. Rptr. 552, 553 (Ct. App. 1966).

12. Although the plain language of the statute is in the conjunctive ("payment of any claim of lien . . . and thereafter in the payment of all or any part of the costs of any work of improvement") (emphasis added), several commentators have misconstrued and misquoted both Code of Civil Procedure § 1188.1 and its successor § 3136 as being in the alternative:

(1) "a lender . . . retains its priority over mechanics' liens for optional advances which are made to pay a recorded mechanic's lien claim or to pay costs of construction."

3 HARRY D. MILLER & MARVIN B. STARR, CALIFORNIA REAL ESTATE 2D § 8:119 (1989) (citing § 3136) (emphasis added). This is clearly wrong.

(2) "If loan disbursements are optional with the lender, then intervening mechanics' liens have priority . . . unless the optional advances are used to pay for the cost of improvement, not exceeding, however, the original obligatory commitment of the lender." CAL. CIV. CODE § 3136 (West Supp. 1991). CALIFORNIA MECHANICS' LIENS AND OTHER REMEDIES 2D § 1.67 Cal. Cont. Educ. of the Bar (1988). This is equally wrong.

(3) "If such noncomplying disbursements are used to pay lien claims or costs of the work of improvement, lender priority may be maintained." Id. at § 8.13 (emphasis added). Wrong again. See CAL. CIV. CODE. § 3136 (West Supp. 1991).

(4) "Former CAL. CIV. PROC. CODE § 1188.1 [now CAL. CIV. CODE § 3136] gives preference to senior construction loans over mechanics' liens for optional as well as obligatory advances, if the funds were used to pay for actual improvements to
This article traces the development of section 3136 from original intent to final enactment. Further, it demonstrates how the section’s form and substance compromises resulted in a legislative scheme that is out of step with the commercial realities it is meant to govern, frustrating the purportedly promoted interests of both lenders and mechanics.

The remainder of this article is composed of four sections: (1) Priority of Construction Liens Before 1957; (2) Legislative History and Analysis of section 3136; (3) The Special Problem of Title Insurance; and (4) Conclusion and Recommendations.

II. PRIORITY OF CONSTRUCTION LIENS BEFORE 1957

A. General Priority Principles

The first rule of lien priority is that “[o]ther things being equal, different liens upon the same property have priority according to the time of their creation.”¹³ In the case of a mechanic or materialman, the time of creation of his or her lien is not the date such mechanic or materialman commenced (or completed) his or her particular work of improvement, nor is the time of creation the date the mechanic’s lien is recorded, but, rather, all mechanics’ liens relate back to the date the first work of improvement was done by any mechanic or when the first materials or supplies were delivered by any materialman.¹⁴

Thus, a deed of trust or mortgage recorded prior to the commencement of any work of improvement on the property will have priority over any subsequently recorded mechanics’ liens. Conversely, a mechanics’ lien is preferred to any lien

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¹⁵ CAL. CIV. CODE § 3134 (West Supp. 1991). Such deed of trust or mortgage will be referred to hereinafter as “First Lien.”
(including a deed of trust or mortgage) that "attaches subsequent to the commencement of the work of improvement, and also to any lien, mortgage, deed of trust, or other encumbrance of which the claimant [the mechanic or materialman] had no notice and which was unrecorded at the time of commencement of the work of improvement."\(^6\)

One of the distinctive features of a construction loan deed of trust is that it secures both initial advances (sums loaned at the time the lien was created) and future advances (sums loaned after the initial advance). The issue for the construction lender is whether the construction loan deed of trust retains its priority as a First Lien as to such future advances.

Prior to 1957 and the amendment of Code of Civil Procedure section 1188.1 (the predecessor of section 3136), it was strongly indicated that:

Although California decisions are few and precedents elsewhere are unsatisfactory ... California courts will follow the rule that if a lender, with notice of accrual of mechanics' liens, makes an advance that he could not be compelled to make, either because the time for the advance has not arrived or some condition for payment thereof has not been fulfilled, the advance is voluntary or optional and therefore subordinate to mechanics' liens.\(^7\)

Thus, prior to 1957, the issue of priorities between a construction lender's First Lien and a mechanics' lien was determined solely by whether any particular advance was characterized as obligatory or optional.\(^8\)

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16. Id.
18. Although the distinction between "optional" advances and "obligatory" advances shall be discussed, this article shall not develop the much needed analy-
B. Obligatory Advances and Optional Advances

Although one commentator in 1957 believed that "under tightly drawn modern loan contracts the lender will always be able to determine whether the advances he makes are optional or obligatory," experience belies that belief. The issue is not, as suggested above, whether the terms of a loan agreement intend one advance to be obligatory (and prior to other liens) and another advance to be optional (and junior to other liens). The issue is whether a lender intending to make an advance secured by a First Lien loses the priority of its First Lien to the extent of such advance if it deviates from the express terms of a loan agreement, or if it elects to advance money after an event of default by the borrower rather than exercise its remedies under the loan agreement.

sis necessary to finally distinguish between the two. One commentator has made the broad suggestion that all advances made for non-construction purposes (e.g., land draw, points, prepaid interest, etc.) are optional and therefore lose their priority as against mechanics' liens. Hunt, supra note 8, at 108 n.10 (1968) (citing Soule Steele Co. v. Brewer, Civil No. 126717 (Cal. Super. Ct., 1967)).


20. One commentator submits:

[T]hat by virtue of the building loan agreements in use today in the construction industry, the lender retains such great control over the building loan funds that any advance made by the lender could be considered an optional advance especially where the borrower had violated or breached one or more of the clauses in the building loan agreement and the lender continued to advance funds, thereby waiving the breach.

Id. (emphasis added).

Another commentator has suggested a drafting technique that merits consideration. The construction loan agreement should make all advances by the lender obligatory until and unless the lender gives the borrower written notice of a default of a specific provision and the borrower fails to cure such default within ten days. Edmund T. Urban, Future Advances and Title Insurance Coverage, 15 WAKE FOREST L. REV. 329, 356 n.97 (1979). However, this author wonders whether a court will permit the construction lender to determine whether any particular advance is optional or obligatory. After all, if a borrower has breached a particular provision of a loan agreement the additional advance is optional to the extent that the lender has the full power to choose between making an advance or delivering a notice of default. How can one be truly obligated to make an advance if the mere giving of notice followed by the passage of time will make the advance optional?
One California appellate court, in *Yost-Linn Lumber Co. v. Williams*, illustrated this distinction between obligatory and optional advances. Ray and Emily Williams obtained a construction loan of five thousand five hundred dollars ($5,500.00) from a mortgage company. Pursuant to the loan agreement, the mortgage company was “not obligated to advance the funds as herein provided, or any part thereof, if said building is not erected in strict accordance with said plans and specifications.” The loan agreement contained the further provision that:

[I]n the event that the work of erecting said building is abandoned for a period of thirty days, then the [mortgage company] may, at its option, but is not obligated to do so, complete said building, using for that purpose the funds remaining in its hands; and any funds so used for such completion shall be deemed as paid to [Williams] under the terms of this agreement; and any costs and charges incurred in the completion of said building in excess of said amount shall be a lien on the hereinbefore described property and be secured in a like manner as the mortgage and trust deed.

On February 28, 1927, the Yost-Linn Lumber Company filed a claim of lien for the materials it had supplied for use on the Williams’ property. On March 10, 1927, the Williams abandoned the construction work on their building. The abandonment continued for more than thirty days and, at the expiration of the thirty days, the mortgage company exercised its option to take possession of the premises and complete construction in accordance with the plans and specifications.

The court found that:

[F]ollowing the 30-day period of abandonment of the work it was not obligatory upon said corporation to advance any further sums of money whatever; and that being so . . . the trial court was correct in finding as it did that the sums of

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22. *Id.* at 325.
23. *Id.* With some allowance for the quaint language of this loan agreement, it appears indistinguishable in legal effect from a model loan agreement set forth at 1 GORDON L. GRAHAM, CALIFORNIA REAL PROPERTY FINANCING 392 app. A (1989).
money expended subsequent to the abandonment of the work constituted voluntary advances, and that having been made after the accrual of the materialmen's liens and with notice thereof, were not the subject of any superior lien.\textsuperscript{25}

Although far from a definitive statement of the law, for this article's purposes, it shall be assumed that a borrower's uncured breach of a loan agreement causes all subsequent advances to be considered optional or voluntary.\textsuperscript{26}

III. LEGISLATIVE HISTORY AND ANALYSIS OF SECTION 3136

A. Background

Clearly, the risk that a First Lien will lose its priority as to optional advances has caused many lenders to be reluctant to make optional advances. As one astute commentator observed there are many instances "where it would be to the advantage of everyone concerned, owner, lender, potential lien claimant and contractor, for optional advances to be made."\textsuperscript{27} This

\textsuperscript{25} Id. at 326.

\textsuperscript{26} Hunt, supra note 8. Cf. Turner v. Lytton Sav. & Loan Ass'n, 51 Cal. Rptr. 552 (Ct. App. 1966) (advance made after execution of declaration of default apparently for failure of work to progress in satisfactory manner is deemed optional, but retains priority by reason of Code of Civil Procedure § 1188.1 (now CAL. CIV. CODE § 3136)); Community Lumber Co. v. California Publishing Co., 10 P.2d at 60 (Cal. 1932) (payment made even though condition not satisfied that prior liens be paid is optional advance); Yost-Linn, 9 P.2d at 524 (advances made after abandonment of project in violation of loan agreement results in advances being deemed optional); Althouse v. Provident Mut. Bldg. Loan Ass'n, 38 P. 1018 (Cal. Ct. App. 1922). But see Dockrey v. Gray, 341 P.2d 746 (Cal. Ct. App. 1959) (interest that is not disbursed, but is accrued and included in lender's foreclosure bid retains priority over intervening liens); Machado v. Bank of Italy, 228 P. 369 (Cal. Ct. App. 1924) (interest payments paid from loan reserve are obligatory and have priority).

To add to the confusion, the court in Manning v. Queen, 69 Cal. Rptr. 734 (Ct. App. 1968), without discussing optional advances versus obligatory advances and without citations, held that an advance of funds by a lender for the payment of delinquent taxes, mortgage insurance premiums, late payment fees and a "loan advancement fee" retained priority as to such payments even though junior lienors could foreclose for the nonpayment of such items.

\textsuperscript{27} Letter from Floyd B. Cerini, Chairman, Legislative Comm., California Mortgage Bankers Ass'n, to Mr. John Bohn, Counsel and Secretary, Senate Interim Judiciary Comm. (Jan. 11, 1957) [hereinafter Cerini], reprinted in SENATE INTERIM JUDICIAL COMM. REPORT ON ASSEMBLY BILL NO. 884, 1 APPENDIX TO JOURNAL OF THE SENATE, CALIFORNIA REG. SESS. OF 1957, 259, 260-62 [hereinafter REPORT ON A.B. 884].
commentator went on to identify the two most common situations in which optional advances are appropriate and should be encouraged:

A typical illustration is a situation where the construction loan agreement provides for the advancement of the loan funds under a five- or six-pay plan . . . It is not unusual for work to progress beyond any one of these stages which in themselves are not yet completed, but yet the contractors and subs cannot get their money until the particular stage entitling the owner or contractor to the loan funds is . . . completed. Under such circumstances it is to everyone's advantage that loan funds be advanced to pay bills which suppliers and materialmen have presented. They want the money and the lender would in most cases be agreeable to advance the loan funds if it could be assured that it would not lose the priority of its lien.

Another illustration is where it turns out that there are insufficient funds to complete a work of improvement, and a lender is agreeable to the making of an additional advance under his deed of trust, but only if the lien of his deed of trust would retain priority over the mechanics' lien claims.

B. The Original Proposal: A.B. 884

In response to these concerns, Assemblyman Bruce F. Allen introduced the following amendment to Code of Civil Procedure section 1188.1 (hereinafter referred to as A.B. 884):

A mortgage or deed of trust which would be prior to any of the liens provided for in this chapter to the extent of obligatory advances made thereunder in accordance with the commitment of the lender shall also be prior to the liens provided for in this chapter as to any other advances, secured by such mortgage or deed of trust, which are used in payment or reimbursement of the payment of all or any part of the costs of any work of improvement on the property which is subject to such mortgage or deed of trust.

If A.B. 884 had been promulgated in its bill form as introduced by Assemblyman Allen, it would have clarified the rela-

28. See infra note 34 for illustration of such pay plans.
29. Cerini, supra note 27, at 262.
tionship and priorities between lenders' liens and mechanics' liens. A First Lien would have remained a First Lien as to all advances of funds used to improve the property regardless of the characterization of any single advance as optional or obligatory.  

C. The First Amendment to A.B. 884

On April 5th, 1957, A.B. 884 was substantially and materially amended as follows:

A mortgage or deed of trust which would be prior to any of the liens provided for in this chapter to the extent of obligatory advances made thereunder in accordance with the commitment of the lender shall also be prior to the liens provided for in this chapter as to any other advances, secured by such mortgage or deed of trust, which are used in payment or reimbursement of any claim of lien as provided for in this chapter which is recorded at the date or dates of such other advances, if any, and thereafter in the payment of all or any part of the costs of any work of improvement on the property which is subject to such mortgage or deed of trust.

As originally conceived, A.B. 884 clarified law and practice in at least two troubling areas related to construction lenders' advances: (1) optional advances made prior to exhaustion of the original loan fund; and (2) additional advances made after exhaustion of the original loan fund. As amended above, A.B. 884 failed to clarify either of the above issues.

1. Optional Advances Made Prior to Exhaustion of Original Loan Fund

Lenders make optional advances prior to the exhaustion of the original loan fund for two reasons. First, the advance might be made pursuant to the waiver of a condition, for example where the lender uses a "progress payment system."

33. The natural corollary of such clarification is that lenders would have been better able to predict the nature and extent of damages not covered by title insurance resulting from the loss of lien priority. For discussion of title insurance problems related to § 3136, see infra text accompanying notes 68-72.
34. In the typical progress payment system, the construction project is divided
and the borrower requests an advance prior to completion of a particular pay stage. Second, there may have been a breach of the loan agreement. For example, the borrower abandons the project and the lender, pursuant to an express provision of the construction loan agreement, completes the project prior to foreclosure, or the lender makes an advance after the borrower breaches a covenant of the loan agreement requiring borrower to keep the property free of mechanics' liens.

In the case of either waiver or breach, A.B. 884, as originally conceived, would have allowed lenders to make such optional advances and retain their all-important First Lien as to such optional advances. Lenders would have merely been required to ensure that the proceeds of the optional advances be used to pay for the costs of construction. This should have been sufficient to protect both mechanics and construction lenders. Since lenders would not have been able to use optional advances for loan fees, points, interest, principal payments, into stages and a certain portion of the loan fund is disbursed directly to the borrower upon the completion of each stage. The borrower receives a set percentage of the full loan amount at the completion of each stage regardless of whether the aggregate amount of the bills from mechanics and materialmen is greater than or less than the portion of the loan amount to be disbursed. Naturally, lenders are frequently urged to disregard or waive satisfaction of certain conditions to the completion of a stage and make an anticipatory advance. 2 ARTHUR G. BOWMAN, OGDEN'S REVISED CALIFORNIA REAL PROPERTY LAW § 20.46 (1975).

Although five-pay plans and six-pay plans are typical, the following seven-pay plan is illustrative of the scheme: 1st installment of 20% of loan amount disbursed when foundation, underground plumbing and floor joists or slab are in place for main structure and rough lumber (except rafters, trusses and sheathing) is on the site; 2nd installment of 15% of loan amount disbursed when rough framing is substantially complete, including rafters; 3rd installment of 20% of loan amount disbursed when finished roof is on (except tile), rough plumbing, rough electrical, rough heating, rough air conditioning and framing are complete; 4th installment of 10% of loan amount disbursed when interior plastering and drywall installation is complete and exterior has brown coat on stucco portions and prime coats of paint on wood portions; 5th installment of 10% of loan amount disbursed when doors are hung, cabinets are installed, and all interior ceramic tile and formica work are complete; 6th installment of 10% of loan amount disbursed when construction is complete and Notice of Completion has been filed; 7th and final installment of remaining 10% of loan amount disbursed upon the occurrence of either of two conditions related to expiration of lien periods. Inspection and Disbursement Schedule (Residential Construction) of Commerce Savings Bank, Sacramento, California.

35. The typical lender will have a system of on-site inspection of physical progress to ensure, for its own benefit, that loan funds are being used for construction purposes. Such on-site inspections should uncover the most common problems of delay: weather, fraud, and incompetence.
or land draws without risking the priority of their First Lien, all advances would have gone towards improving the property and, presumably, enhancing the value of the security of all lienholders.

2. Additional Advances Made After Exhaustion of Original Loan Fund

In addition to the issue of anticipatory or optional advances made prior to the exhaustion of the original loan fund, lenders must be concerned with the priority of their First Liens when making additional advances to complete a construction project if the original loan amount turns out to be insufficient to complete construction. Typically, there are three situations in which the original loan commitment turns out to be insufficient to complete the project. For one reason or another, the original estimates of construction costs are inaccurate. The borrower may be unscrupulous and the lender careless, for example where the borrower diverts loan funds from one project to fund another project. Finally, a crooked borrower may divert loan funds for personal use.36

The issue may be restated: Who is to bear the risk of loss where the original loan commitment is insufficient to complete the work of improvement? As originally conceived, A.B. 884 proposed a balanced approach. The lender ensures that additional advances are used solely to pay the costs of construction, and the mechanics share the risk pro rata that the completed work of improvement will equal the value of the labor or materials they have contributed. As amended, A.B. 884 requires lenders to first ensure that all mechanics who have recorded

36. See CAL. PENAL CODE § 506 which states:

[A]ny contractor who appropriates money paid to him for any use or purpose, other than for that which he received it, is guilty of embezzlement, and the payment of laborers and materialmen for work performed or material furnished in the performance of any contract is hereby declared to be the use and purpose to which the contract price of such contract, or any part thereof, received by the contractor shall be applied.

This 1919 amendment to Penal Code § 506 has been held to be unconstitutional and an invalid exercise of police power if it is construed as making it embezzlement for a contractor to merely breach his or her agreement with mechanics and materialmen. People v. Holder, 199 P. 832 (Cal. Ct. App. 1921). See also People v. Bullock, 268 P. 1059, (Cal. Ct. App. 1928); American Surety Co. v. Bank of Italy, 218 P. 466 (Cal. Ct. App. 1923).
mechanics' liens are reimbursed. Only then may the lender allow additional advances to be used to pay for the costs of the construction. Therefore, lenders are required to play the same intensive administrative role regardless of whether the borrower is honest and capable or dishonest and incompetent. However, as discussed below, the final amendment to A.B. 884 foreclosed the possibility of advancing funds after the exhaustion of the original loan fund.

D. The Second Amendment to A.B. 884

On May 8, 1957, the Senate further amended and adopted A.B. 884, as amended, as follows:

A mortgage or deed of trust which would be prior to any of the liens provided for in this chapter to the extent of obligatory advances made thereunder in accordance with the commitment of the lender shall also be prior to the liens provided for in this chapter as to any other advances, secured by such mortgage or deed of trust, which are used in payment of any claim of lien as provided for in this chapter, if any, which is recorded at the date or dates of such other advances, if any, and thereafter in the payment of all or any part of the costs of any work of improvement on the property which is subject to such mortgage or deed of trust; provided, that the priority of such mortgage or deed of trust shall not exceed in total for both obligatory advances made in accordance with the commitment of the lender and other advances the amount of the original obligatory commitment of the lender as shown in said mortgage or deed of trust.98

This second amendment to A.B. 884 resolves one important issue unsatisfactorily, yet completely. The lien securing an additional advance to complete a project after the original loan fund is exhausted will be junior in priority to all mechanics' liens, whether such mechanics' liens are recorded prior to the time of the additional advance or recorded after the time of the additional advance.99

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37. This author cannot explain the switch in positions of "if any," whether for reasons of logic, syntax, or grammar.

38. CAL. CIV. PROC. CODE § 1188.1 [now CAL. CIV. CODE § 3136], REPORT ON A.B. 884, supra note 27, at 263 (redlining added).

39. As one commentator at the time stated:
Under these circumstances, lenders have no choice but to foreclose and wipe out all junior liens (i.e., all mechanics' liens). No system to ensure payment of recorded mechanics' liens will be sufficient. Unrecorded mechanics' liens will have priority over First Liens as to additional advances in excess of the original obligatory amount of the loan. Title insurance coverage is, of course, lost. It is now impossible to guarantee the priority of a First Lien securing additional advances beyond the original loan amount.

E. Alternative Trust Fund Proposals

It has been recognized that the typical loan agreement imposes no burden upon construction lenders "to see that the money advanced thereunder was, in fact, applied to payments for labor and materials furnished in the construction work. Hence, any payments made to or on behalf of [a borrower] were in discharge of the agreement of [a construction lender] and brought it under no liability to the [mechanic] lien claimants."40

The clear effect of the proposals finally promulgated as section 3136 is to make lenders responsible for the payment of mechanics and materialmen. If the lender desires to ensure the priority of his security, unless such advances are used to pay mechanics' liens.

By limiting the priority to the amount of the original obligatory commitment, the amendment carries the implication that the "obligatory" nature of the advances is no longer dependent solely on the amount which the lender has obligated himself to loan . . . , but also on the purpose for which the money was loaned. Therefore, while the effect of the amendment will depend on the interpretation of "obligatory" as defined in each contract, it is possible that if the lender does not insure that his advances are used for the purpose for which the loan was contracted, he will, to the extent of the advances, lose the priority of his security, unless such advances are used to pay mechanics' liens.


priority of its First Lien as to optional advances, it must oversee payment of mechanics from the loan funds. In effect, the lender holds the undisbursed loan funds in trust for the benefit of mechanics and materialmen.41

Whether by happenstance or design, two "trust fund" proposals were being debated in the California legislature at approximately the same time as the amendments to A.B. 884 were introduced.42 S.B. 2194 provided that, if a lender satisfied one of the two following conditions, the lien of the lender securing "future advances" would be prior to the liens of mechanics and materialmen. The lender could qualify for priority posting by a labor and material bond inuring to the benefit of mechanics and materialmen. Additionally, the lender could qualify for priority if the lender and borrower execute a writing (which may be the deed of trust itself or a separate loan agreement):

[P]roviding in substance and legal effect that . . . [t]he funds to be so advanced by the lender shall be a trust fund devoted solely to the purpose of paying laborers, subcontractors, materialmen, segregated contractors, and others,

41. This "trust" theory is in some ways reminiscent of the equitable mechanics' lien asserted in a line of cases commencing with Smith v. Anglo-California Trust Co., 271 P. 898, 900-02 (Cal. 1928), but later eliminated by the legislature in 1967 by its promulgation of Civil Code § 3264. See Nibbi Bros., Inc. v. Home Fed. Sav. & Loan Ass'n, 253 Cal. Rptr. 289 (Ct. App. 1988). As the Nibbi court stated, the judicial expansion of the equitable mechanics' lien doctrine "appeared to prevent lenders from applying unexpended construction loan funds to the repayment of the developer's debt until the rights of all subcontractors and materialmen had been settled, consequently increasing their financial exposure." Id. at 291. The Nibbi court further recognized that Civil Code § 3264 drew a fair line between:

[T]he contractors, subcontractors and materialmen on the one hand and the construction lenders on the other. The former at least have remedies by mechanics' lien against the property, unbonded stop notices against the owner, and action upon the contract against the person or persons personally ordering the labor or material. The latter are relieved of the expense and risk of policing the ultimate distribution of construction funds and can concentrate on their primary duty of providing construction loans at lesser expense to the borrower and ultimately to the consuming public.

Id. at 292. The same fair line drawn in Civil Code § 3264 is skewed in § 3136.

42. A.B. 1452, CAL. LEGIS. REG. SESS. (1957) (proposing to characterize funds received by contractor or subcontractor as a trust fund for payment of materials, labor and supplies); S.B. 2194, CAL. LEGIS. REG. SESS. (1957) [hereinafter S.B. 2194].

43. Cf. CAL. CIV. CODE § 3138 regarding the posting of bonds.
who under the statutes of the State of California, are entitled to mechanics' liens on such work of improvement then or thereafter engaged upon in connection with such work of improvement and that the borrower shall not have any beneficial interest in said funds unless and until said purpose has been fulfilled."

S.B. 2194 also provided that a lender would have no right to apply any undisbursed sums to the reduction of principal or to the payment of any installment of principal or interest until amounts owing on all valid liens recorded against the project property and amounts owing on any valid notices to withhold filed with such lender had first been paid. Finally, valid liens recorded by mechanics would be prior and paramount to those of the lender securing advances used for:

[F]urther work of improvement or the payment of bills for such further work, but there must be satisfied before funds shall be used for the last mentioned purpose, all existing stop notices and notices of mechanics' liens for work or materials already done or furnished before any part of the residue of said fund undisbursed can be used for further work of completion on said improvement.

Thus, a textual analysis suggests that the form of A.B. 884 as originally proposed was retained, but the substance of the various "trust fund" proposals was adopted. As promulgated in its final form, section 3136 places the burden of protecting

44. S.B. 2194(1)(b)(1), supra note 42, at 265. A.B. 1452 proposes a similar trust fund methodology.
46. Id.
47. Section 1188.1 of the Code of Civil Procedure was repealed in 1969 and recodified. The first paragraph Code of Civil Procedure § 1188.1 was reenacted as Civil Code § 3134 and the second paragraph of Code of Civil Procedure § 1188.1 (i.e., the final version of A.B. 884) was reenacted as § 3136 as follows:

A mortgage or deed of trust which would be prior to any of the liens provided for in this chapter to the extent of obligatory advances made thereunder in accordance with the commitment of the lender shall also be prior to the liens provided for in this chapter as to any other advances, secured by such mortgage or deed of trust, which are used in payment of any claim of lien, if any, which is recorded at the date or dates of such other advances and thereafter in the payment of all or any part of the costs of any the work of improvement on the property which is subject to such mortgage or deed of trust, provided, that the priority of such mortgage or deed of trust. Such priority shall not, however, exceed in
mechanics and materialmen upon the lenders. Under both section 3136 and the "trust fund" proposals, the remedy in the event lenders fail to ensure that mechanics and materialmen are paid for their services and materials is the loss of priority of the lender's lien. Other than the characterization of the loan funds as a trust fund (presumably characterizing the lender as a trustee), there is little to distinguish section 3136 as it finally became law from the trust fund proposals then pending before the California legislature.

However, the time A.B. 884 was being debated one commentator had a very different interpretation of the proposed statute:

The net effect of [A.B. 884] would be to amend existing law to provide that where the deed of trust contains provision for optional advances and the said optional advances are in fact made and money received therefrom is used for payment of services or material which go into a construction project, then the priority of the deed of trust for all moneys advanced thereunder including optional advances will be as of the date the deed of trust is recorded which means, in normal situations prior to mechanics' liens.48

If the intent of the legislature is accurately reflected in the comments of the legislative counsel quoted above, the drafters badly missed their mark. The plain language of the statute grants priority only to liens securing optional advances used for the payment of recorded mechanics' liens and thereafter used for the payment of the costs of services and goods used for construction. The only mechanics' liens that are inferior to such optional advances are those mechanics' liens not actually of record at the time of the optional advance.

Recourse to judicial expressions of legislative intent to resolve this apparent conflict with the plain meaning of section

48 Counsel for the Senate Comm. on Judiciary, Comments, reprinted in REPORT ON A.B. 884, supra note 27, at 262-63.
3136 are of no avail. Courts have stated clearly that the mechanics' lien laws are remedial and should be broadly construed to protect mechanics. Yet courts have stated that the Civil Code sections prescribing rules for determining priority are designed for the protection of those who take security interests in land as well as for the protection of mechanics' lien claimants. Although one court has used the legislative counsel's expression of legislative intent to justify the extension of section 3136's reach to junior liens other than mechanics' liens, no other court has used it to preserve a First Lien as to an optional advance that was not used as section 3136 requires.

IV. ANALYSIS OF SELECTED ISSUES

A. Incentive to Foreclose

As adopted, Code of Civil Procedure section 1188.1 (now section 3136) makes foreclosure the remedy of choice for lenders confronted with a breach of a construction loan agreement. Negotiation and workouts are not viable alternatives because no advance after a breach can be legally compelled. Therefore, in order to made an optional advance and maintain any pre-existing priority, lenders must ensure that recorded mechanics' liens are paid first and thereafter ensure that all further advances are used to pay for the costs of construction.

Where the original loan fund is exhausted and the lender is confronted with a choice between instituting a foreclosure action or making an additional advance to complete a project, the lender may consider foreclosure the only viable alterna-

49. Patten-Blinn Lumber Co. v. Francis, 333 P.2d 255, 260 (Cal. App. 1958); Gallagher v. Campodonico, 5 P.2d 486 (Cal. App. 1931); cf. Bottomly v. Rector of Grace Church, 2 Cal. 90 (1852) (statute prior to 1879 Constitution giving a lien to mechanics is in derogation of common law and should be strictly construed).
52. See, e.g., Foellmer v. Midway Lime & Cement Co., 6 P.2d 333 (Cal. Ct. App. 1931). In Foellmer, a first deed of trust and second deed of trust attached prior to the commencement of construction of a single family residence. The court held that foreclosure of the second deed of trust wiped out junior mechanics' liens and subsequent optional advances under the theory that the first deed of trust retained priority because mechanics had no lien against the real property.
In this situation, lenders will not risk the priority of their First Liens, nor will lenders advance funds to mechanics who have already completed their work or delivered their materials. Such advances will not in any way enhance the value of the lender's security. Therefore, lenders will foreclose.

If the lender is the successful bidder at the foreclosure sale, it will take the property free of all junior liens, including mechanics' liens. The lender will then complete the project using the same funds that it would have been willing to advance to the borrower absent the madate of section 3136. Finally, the lender will sell the now-completed project with some hope that it will not only recoup the original loan amount plus accrued interest, but that it may turn a profit. If the lender is the unsuccessful bidder at the foreclosure sale, the lender will be paid off in full, and the successful bidder will take the property free of all liens. In either event, this legislative scheme virtually guarantees greater losses to junior lienholders. This result occurs because junior liens become more frequently foreclosed by the First Lien than if the construction lender were permitted to make optional advances to pay for the costs of construction, thus enhancing the value of the security held by all lienholders.

B. Preferences Among Mechanics

In addition, section 3136, as finally adopted by the legislature, introduced, without discussion, a significant new issue: Why is the class of mechanics and materialmen who complete their work or deliver their materials in the early stages of a construction project preferred over the class of mechanics and

53. In the event loan funds are insufficient to complete a project (and the lender is unwilling to advance additional funds), the typical loan agreement will require borrowers to deposit sufficient funds to complete the project with the lender. Although some borrowers will have the wherewithal to complete the project using their own funds, most borrowers will have to seek independent financing. Such independent financing may require security other than a deed of trust or mortgage on the project property. After all, the project property will have a trust deed and numerous junior mechanics' liens superior in priority to any new security interest. To obtain new financing in this situation seems unnecessary, and unnecessarily burdensome, compared to allowing the original construction lender to advance sufficient funds to complete the project secured by an existing First Lien.
materialmen who complete their work or deliver their materials in the later stages of a construction project?\textsuperscript{54}

In most other contexts, mechanics' liens are considered to be equal regardless of the time the claimants performed their labor or delivered their materials.\textsuperscript{55} Section 3136 protects the interests of those mechanics who have recorded their liens. However, their protection comes at the expense of those mechanics who have not yet recorded liens. One can only wonder why section 3136 should not be as "applicable to the claimants putting in the foundation, or the rough plumbing, as it is to the carpenter driving in the last spike."\textsuperscript{56} It seems axiomatic that "all other factors being equal the rights of one contributing to the construction should not depend on the state thereof at which his contribution was made."\textsuperscript{57}

C. Oversight Systems

By adding the phrase "and thereafter" rather than "or" to section 3136, the legislature expressly mandated that lenders who desire to retain the priority of their First Liens as to optional advances must institute a more elaborate oversight system to ensure that advanced funds are first used to pay mechanics who have recorded liens. The lender might institute a more costly, but more efficient, "voucher system"\textsuperscript{58} to disburse loan funds. The voucher system is neither simple nor cheap. It requires a much larger administrative staff and is primarily used by larger lending institutions.\textsuperscript{59}

\textsuperscript{54} It is also curious that § 3136 provides such an obvious incentive for mechanics to record liens early even though they could wait until after the completion of the entire work of improvement to file their claim of lien.


\textsuperscript{56} McBain v. Santa Clara Sav. & Loan Ass'n., 51 Cal. Rptr. 78 (Ct. App. 1966) (analyzing the doctrine of equitable liens). See supra note 41.

\textsuperscript{57} Id.

\textsuperscript{58} In a voucher system, the mechanic bills the borrower, or the contractor acting as the borrower's agent. The borrower or contractor then provide the mechanic with a voucher in the full amount of the bill. The mechanic presents the voucher to the lender who pays the mechanic. The typical voucher form includes a release of mechanics' lien and stop notice rights. See CAL. CIV. CODE § 3262 (West Supp. 1991).

\textsuperscript{59} Smaller lending institutions can contract with voucher control companies. The charge, of course, is passed through to the borrower and, ultimately, to the consumer.
In the alternative, the lender might institute a system to search title prior to each advance and obtain releases from all mechanics who have recorded liens at the time of the advance. However, unless the lender utilizes an escrow to pay mechanics, such a title search remains problematic. A title search must be made at some set point in time, typically 8:00 a.m., while progress payments will be advanced sometime after the title search, typically at the end of the work day. Thus, the lender bears the risk of loss due to an intervening mechanics' lien recorded prior to the time of the advance and after the title search.

As one court recognized in a similar context, if lenders are "relieved of the expense and risk of policing the ultimate distribution of construction funds [they] can concentrate on their primary duty of providing construction loans at lesser expense to the borrower and ultimately to the consuming public."

D. Disputed Mechanics' Liens

Section 3136 does not provide alternatives in the case of a disputed mechanics' lien. Consider the following paradigm. A mechanic records a lien prior to an advance of loan funds. The borrower vehemently denies that any money is owed the mechanic. Should the lender make an advance after the date of the recorded, albeit disputed, mechanics' lien? As keeping the subject property free of mechanics' liens is a covenant of the typical loan agreement, the advance is optional, so the lender risks the priority of its First Lien as to all advances made after...

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60. One particularly troubling aspect of § 3136 is that it only preserves the priority of advances that are first "used in payment of any claim of lien." What of advances made after liens have been released absent payment, whether by reason of negotiation, settlement or workout? There is nothing in the plain language of § 3136 or its legislative history that can be used to rebut an argument that a First Lien loses its priority as to optional advances after a mechanics' lien has been released, but not paid.

61. This is what most lenders expect from their "122" endorsements. See infra text accompanying notes 68-72. The lender might also institute other fiscal controls such as a call for receipted bills or the issuance of joint checks.

62. See infra text accompanying notes 68-72 regarding lack of title insurance coverage for damages suffered due to loss of priority to mechanics' liens by reason of making an optional advance.

the date the mechanics' lien is recorded. It is unlikely that any lending institution will be sufficiently reckless as to risk the loss of priority as to such advances. To foreclose for breach of the covenant to keep the subject property free of mechanics' liens in this case, however, is a harsh and inefficient remedy. It is inconceivable that the legislature intended to permit one disgruntled mechanic to record a lien and hold up an entire project. Yet, this is the unintended consequence of a requirement that loan funds be used first to pay recorded mechanics' liens and thereafter to pay the costs of construction.

E. Enhancement of Security

One commentator has suggested that:

The senior may respond [to the loss of priority] that even if the later payments were optional, they were nevertheless necessary to protect the security. Because a half-finished project is a liability, and since the remaining payments actually improved the property, benefitting juniors as well, the lender should not be denied priority. 64

To cite section 3136 is both wishful and puzzling. To retain priority under section 3136, optional advances must first be used to pay recorded lien claimants. This would do little to assist a lender faced with a defaulting borrower, a half finished building, and insufficient loan funds remaining to complete the project. However, the commentator is quite correct that the law must recognize that an advance to improve the property benefits all creditors, both senior and junior, and should be encouraged. Unfortunately, the plain meaning of section 3136 resists this desirable interpretation.

In addition, one court has already addressed this proposition and found it wanting. In a fact pattern similar to Yost-Linn, a lender claimed that it was necessary to advance funds to protect its security after the borrower abandoned the construction project. In determining that the advances made were optional, the court responded to the argument that California Civil Code section 3136 should protect the lender's priority. "We fail to see how the advancements became obliga-

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64. ROGER BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 5.27 (2d ed. 1990) (citing, inter alia, CAL. CIV. CODE § 3136).
tory in any sense, except that for its own interest appellant may have felt obliged to complete the building, so that the property might be sold to better advantage.” The court, however, cryptically added, “[b]ut so far as the evidence shows, the property as it stood at the time when the work of construction was abandoned by the [borrower] was sufficient in value to protect the $3,000 loan theretofore made by appellant.”

As of the date of this article, no court has yet seized this language, written before the promulgation of section 3136 and its predecessors, to permit a lender to prove that an advance made after abandonment remained obligatory when necessary to preserve the value of the lender’s security. To allow lenders to proffer such proof would certainly sharpen the knife necessary to cut the Gordian knot tied by the California legislature when it adopted section 3136.

F. Extension to All Liens

To complete the puzzle of section 3136, one California appellate court extended the reach of section 3136 beyond mechanics’ liens to all junior liens:

We think it clear that the Legislature intended to change the existing case law with respect to the priority of optional advances used, as in the instant case, for ‘the payment of all or any part of the costs of any work of improvement on the property which is subject to such mortgage or deed of trust.”

Although somewhat beneficial to lenders, it is unlikely that the Turner court’s statement of legislative intent is correct. It seems that the court misread California Civil Procedure Code section 1188.1 (now California Civil Code section 3136). Under the Turner court’s interpretation, so long as there are no recorded mechanics’ liens and the advanced funds are used to pay for the costs of improvement, the holder of the First Lien can make an optional advance and retain the priority of its First Lien over unrecorded and inchoate mechanics’ liens as well as any other junior lien encumbering the property. How-

66. Id.
ever, the beneficial effect of even this interpretation is extremely narrow. There is no reason to suspect that the limitation of priority to the original obligatory commitment of the lender does not apply with equal force and effect to junior liens as it does to mechanics' liens.

The Turner court's interpretation must also be criticized on other grounds. The apparently long and ignoble tradition of misreading and misinterpreting section 3136 continues here. Code of Civil Procedure section 1188.1 (now Civil Code section 3136) explicitly stated that it was limited to the issue of priority of mortgages and deeds of trust "to the liens provided for in this chapter." At the time of the Turner decision, in 1966, Code of Civil Procedure section 1188.1 was found in Chapter 2, Title 4 of the Code of Civil Procedure. (Section 3136 is found at Article 6, Chapter 2, Title 15 of the Civil Code.) The Turner court ignored the fact that the junior deed of trust in question was a purchase money deed of trust and was undoubtedly created under Chapter 2, Title 14 of the Civil Code, and was not "provided for" in any way in Chapter 2, Title 4 of the Code of Civil Procedure at that time.

V. THE SPECIAL PROBLEM OF TITLE INSURANCE

A. Generally

The fact that the financial damage caused by a loss of priority as to optional advances may not be covered by title insurance is of particular concern to the construction lender. Thus, the construction lender bears the full loss caused by reason of the loss of priority as to any portion of its First Lien. This result is because no title insurer:

[W]ill insure a lender against loss of priority by reason of ... an optional advance arising by reason of a voluntary deviation from the terms of a construction loan agreement or by reason of the exercise of some option in the construction loan agreement. This would be true because obviously the control of the advance of loan funds is with the lender who, by his own act in making an optional advance, creates a loss of priority of lien.68

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68. Cerini, supra note 27, at 261.
B. Title Insurance of First Liens Securing Optional Advances

The standard construction loan policy, ALTA Loan Policy—1970, provides limited coverage in insuring the priority of the lien securing the loan from purportedly superior mechanics' liens. The coverage, however, is "only against liens arising out of work funded by the proceeds of the loan secured by the insured mortgage which were advanced at Date of Policy or which the insured was then obligated to advance." Although this insurance coverage is significant, it fails to provide all the coverage needed by the typical construction lender.

Under the express terms of the construction loan policy, title insurers only insure obligatory advances. This is so even

69. "Most institutional lenders in California declined to use the ALTA Construction Loan Policy—1975, using instead the ALTA Loan Policy—1970 as the standard construction loan policy, because it provided coverage for the priority of the loan over mechanics' liens." John L. Hosack, California Title Insurance Practice § 3.3 (Supp. 1990).

70. Id.


The ALTA Loan Policy—1970 provides coverage for losses due to:

Any statutory lien for labor or material which now has gained or hereafter may gain priority over the lien of the insured mortgage, except any such lien arising from an improvement on the land contracted for and commenced subsequent to Date of Policy not financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance.

However, the ALTA Loan Policy—1970 excludes from coverage, defects, liens, encumbrances, adverse claims, or other matters: "(d) attaching or created subsequent to Date of Policy (except to the extent insurance is afforded herein as to any statutory lien for labor or materials . . . )."

The ALTA Loan Policy—1970 has now been superseded, if not yet fully implemented, by ALTA Loan Policy—1987.

The theme that runs through [the insuring and excluding provisions of the ALTA Loan Policy—1987] is the determination that it is only in those cases where the mechanics' lien claim arises out of a work financed with insured mortgage, which the insured has advanced at Date of Policy or is obligated to advance, that the priority of the insured mortgage is assured.

This is not a change of coverage from the 1970 Form Policy, but the clarity with which it is now stated will surely cause many lenders to realize that they may not have been getting all of the coverage they expected under the 1970 Loan Policy.

Id. at 151.
though section 3136 allows lenders to retain priority as to optional advances when its conditions precedent are satisfied.

Some construction lenders, aware of the lack of coverage provided by the basic title insurance policy, purchase endorsements designed to insure the priority of liens securing optional advances. For example, CLTA Form 122 endorsement states in relevant part:

The [Blank Title Insurance] Company assures:

(1) That, except as otherwise expressly provided herein, there are no liens, encumbrances or other matters shown by the public records, affecting said estate or interest, other than those shown in said policy, except: ______


(4) That the advance hereinafter referred to is secured by the mortgage referred to in Schedule A; that, as shown by the public records, said mortgage as to such advance is prior to any liens, encumbrances and other matters affecting said estate or interest other than those shown in Schedule B as prior to said mortgage and in paragraph (2) herein, except: ______

Upon assurance by the Insured that said Insured has made an advance to _______, in the sum of _______ Dollars ($_______), which is a portion of the indebtedness evidenced by the note or notes secured by said mortgage, the Company hereby insures against loss which the Insured shall sustain in the event that the assurances of the Company herein shall prove to be incorrect, or by reason of the establishment of priority over the lien of said mortgage upon said estate of any statutory lien for labor or material arising out of the work of improvement under construction or completed at the date hereof.

The effect of provisions (1) and (4) above is to obligate construction lenders to ensure that recorded mechanics' liens are paid from the proceeds of the advance being insured. Otherwise, the priority of the lien securing such advance is not insured as to such recorded mechanics' liens. To this extent, the CLTA endorsement harmonizes with section 3136 in that in order to retain priority, advances must first be used to pay off recorded mechanics' liens.

The first half of the first insuring provision, providing that losses which occur in the event the assurances are incorrect are
insured, is merely the risk assumed by the title insurance companies that their title searches might not be one hundred percent correct. The second half of the first insuring provision, providing that losses caused by reason of the loss of priority to mechanics' liens are insured, appears on first analysis to give lenders the comfort they have been seeking. It might be read to say that losses incurred by lenders resulting from the loss of priority of their First Liens as to optional advances are insured. However, what is given is quickly taken away with the third provision of the CLTA endorsement, providing, "This indorsement is made a part of said policy and is subject to the Schedules, Conditions and Stipulations therein, except as modified by the provisions hereof."

Specifically, ALTA Loan Policy—1970 excludes from coverage "[d]efects, liens, encumbrances, adverse claims, or other matters . . . created, suffered, assumed or agreed to by the insured claimant." Again, title insurers will not insure losses arising from the voluntary acts of the insured lenders. The loss of priority of First Liens as to optional advances is caused by the voluntary act of the lender. The endorsement neither insures that the advance is obligatory nor insures that, if optional, it retains priority.

ALTA Construction Loan Policy Endorsements A through D, as updated, to conform to the 1987 Loan Policy, clarify the extent of the lack of coverage for optional advances. For example, ALTA Construction Loan Policy Endorsement D insures that "the owner of the indebtedness secured by the insured mortgage against loss or damage sustained by reason of lack of priority of the lien of the insured mortgage over any statutory lien for services, labor or materials heretofore or hereafter furnished."

However, this apparently straightforward broad endorsement specifically does not "insure against loss or damage by reason of failure by the insured to comply with or to enforce the provisions of any agreement to which the insured is a party

72. What was true in 1957 remains true today: No title insurance company will insure a lender against loss of priority by reason of the voluntary deviation from the terms of a construction loan agreement. See supra text accompanying note 68.

73. ALTA Construction Loan Policy, Endorsement D, 1987 ed.
which relate to advancing the proceeds of the loan secured by
the insured mortgage."

VI. CONCLUSION AND RECOMMENDATIONS

With no statutory protection and no insurance coverage,
lenders must act as overseers of construction borrowers for the
benefit of mechanics in order to ensure the priority of liens
securing optional advances. No trustee obligation could result
in more oversight by lenders for the protection of mechanics
and materialmen than is now offered by section 3136.

The lender's inevitable reaction to such a high obligation
is to shed both the trustee's obligation and the mechanics'
liens by early foreclosure. If the best laid schemes of mice and
men gang aft a'gley, it should not be surprising that incoherent
and piecemeal legislative schemes like the mechanics' lien laws
fail to serve their intended purpose.

A. Creation of Guarantor Subsidiary

Construction lenders do have a mechanism for obtaining
and preserving the priority of their First Lien as to the entire
loan amount. Lenders may advance the entire amount commit-
ted to be loaned prior to the commencement of the work of
improvement. Although this preserves the construction
lenders' First Liens as to the total loan amount, lenders are
reluctant to simply give the borrowers a great deal of cash with
no control over how the money is spent.

However, the lender can enjoy the control it desires and
preserve its priority as to the full amount of the loan commit-
ment by organizing a wholly-owned subsidiary to act as guaran-
tor. As a condition of the construction loan, the borrower
would be required to enter into an agreement with the guaran-
tor/subsidiary that would provide the guarantor/subsidiary
control over disbursements through a draw or voucher system.
As consideration for the guaranty, the borrower pays one or
more points to the guarantor/subsidiary.

74. Id.
75. The author wishes to thank his partner, William S. Hunter, for this cre-
ative and intriguing concept.
76. The borrower will also be liable for interest on the full amount dis-
bursed, but this can be offset by the interest earned on the principal balance
In the event of a default by the borrower, the lender proceeds directly against the guarantor/subsidiary for the entire amount of the loan. The guarantor/subsidiary pays off the lender. The now-subrogated guarantor/subsidiary not only has the same rights as the lender (i.e., a first lien on the real property as to the entire amount of the loan), but also has a lien on the unexpended loan proceeds. Because the guarantor/subsidiary has the ability to release its lien on the cash without releasing its lien on the real property, it can undertake what the lender could not, advance funds to materialmen after an event of default.

Of course, the guarantor/subsidiary structure may prove to be problematic for some lenders. Capitalization requirements, banking regulations, and systemic complexity might combine in ways too burdensome for the average lender to endure. The implementation of guarantor/subsidiaries to accomplish nothing more than the circumvention of muddled mechanics' lien law might prove, however, to be the impetus for legislative reform.

B. Legislative Reform

If patriotism is the last refuge of the scoundrel, the call for legislative action is the last refuge of the lawyer confronted with an archaic constitutional provision and a befuddling array of judicial and legislative actions. And yet, there is little choice.

The question is not whether a California court will analyze section 3136 and find that certain mechanics' liens have priority over a lender's First Lien as to optional advances. This is inevitable. The question is whether construction lenders will respond by strictly adhering to the express terms of their construction loan agreements, failing to waive otherwise waivable

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77. Because the guarantor/subsidiary must be able to pay off the lender, the guarantor/subsidiary must be adequately capitalized.

78. Cf. STATE BAR OF CALIFORNIA, FINAL REPORT OF COMM. TO STUDY 1958 CONFERENCE RESOLUTION NO. 70, Sept. 11, 1962 (calling for establishment of law review commission to study mechanics' lien laws).
conditions, and foreclosing, rather than negotiating a workout, in the event of any and all breaches of express covenants. Indeed, they have not.

The interests of mechanics and junior lienholders are not advanced by the completion of a half-finished building after their interests have been foreclosed. Mechanics and junior lienholders may be benefitted, however, by giving lenders an incentive to advance funds to complete construction. This change would increase the value of the underlying security for mechanics and junior lienholders, as well as construction lenders. Therefore, section 3136 should be amended so as to implement A.B. 884 as originally proposed. Liens securing optional advances that would otherwise be subordinate to mechanics' liens should retain their priority if the optional advances are used to pay or reimburse for actual costs and expenses of the work of improvement.79

79. See supra text accompanying note 30.