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SECURITY TRANSACTIONS: MECHANIC'S EQUITABLE LIEN ON CONSTRUCTION LOAN FUNDS

In addition to the well-recognized remedies available to suppliers of labor or materials under Sections 1181 and 1190.1(h) of the Code of Civil Procedure, and by general contract action against the owner and/or contractor, the California courts in *Smith v. Anglo-California Trust Co.*¹ and *Pacific Ready-Cut Homes v. Title Ins. & Trust Co.*² established the doctrine of an equitable lien upon the funds of a construction loan. This doctrine is still in force and is recognized by the courts today.

DEVELOPMENT OF THE DOCTRINE

The California interpretation of the equitable lien doctrine as it influences the rights of mechanic's lien claimants first appeared in *Smith*. In this case an owner-builder died before completion of the improvements and the mechanic's lien claimants were denied access to the construction loan funds under the third-party beneficiary theory. However, the court held:

What we have said, however, need not necessarily prove fatal to the cause of the appealing mechanics' lien claimants if there exist any special circumstances warranting the imposition in their favor of a charge or lien upon the *fund* now in dispute. We are of the view that the money remaining undisbursed . . . be so charged. And this by reason of those special circumstances and conditions of representations and conduct upon one side and of action founded thereon upon the other.³ (Emphasis added.)

The equitable lien doctrine thus established in the *Smith* case was followed in *Pacific Ready-Cut Homes*. In this case the court was confronted with claims of liens by mechanic's and materialmen after the borrower had defaulted upon payment of the construction loan. The court reviewed *Smith* and held, "The essential basis of the opinion is the justifiable reliance upon the fund by the lien claimants."⁴ Such reliance was found after consideration of the evidence disclosed that the materialmen had refused to take a con-

¹ 205 Cal. 496, 271 Pac. 898 (1928).

² 216 Cal. 447, 14 P.2d 510 (1932).

³ *Smith v. Anglo-California Trust Co.*, 205 Cal. 496, 502, 271 Pac. 898, 901 (1928).

⁴ *Pacific Ready-Cut Homes v. Title Ins. & Trust Co.*, 216 Cal. 447, 450, 14 P.2d 510, 511 (1932).

tract because the owner was insolvent and the subject property was heavily encumbered, but the materialmen were told of the construction loan and thereupon obtained assurance from a representative of the lender that the proceeds of the loan would be used to pay for material and labor. In ruling for the lien claimants the court held:

The defendant mortgage company, having received the benefit of the plaintiff's performance in the form of a completed building and therefore a more valuable security for its note, 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 plaintiff in rendering his performance.⁵

Requirements for Equitable Lien

The *Smith and Pacific Ready-Cut Homes* decisions created the equitable lien theory based upon certain well-defined factual situations. These may be summarized as follows:

1. The work of improvement had actually been completed.
2. The value of the completed improvements subject to the lender's prior security interest was at least equal to the amount of the loan.
3. There was evidence that the lien claimant in fact relied upon the construction fund for payment for his labor or materials supplied.
4. The position of the borrower or lender was such that to permit either to retain any surplus in the loan fund remaining after completion of the work would have unjustly enriched either or both of them at the expense of the lien claimants.⁶

In both *Smith* and *Pacific Ready-Cut Homes*, the court emphasized the fact that the improvements were in fact completed, and that the balance remaining in the construction loan accounts was sought to be diverted either to the borrower (*Smith*), or to the lender (*Pacific*), to the exclusion of unpaid suppliers. Such diversion would clearly be inequitable since in both situations the borrower-owner had his completed structure and the lender had its full security.

Bearing in mind the factual situations which gave rise to the equitable lien doctrine, it is readily understood why the courts have

⁵ *Id.* at 452, 14 P.2d at 512.

⁶ Brief for the California Savings and Loan League as *Amicus Curiae*, p. 26, A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 394 P.2d 829, 40 Cal. Rptr. 85 (1964).

been reluctant to accept the argument of claimants if the construction of the improvements is not completed, or there is no evidence of representations by the lender resulting in reliance upon the fund by the labor or material supplier.

In a recent decision, *A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n*, the court held:

An equitable lien may be imposed on a construction-loan fund only if it is established that the borrower or lender *induced* the supplier of labor or materials to rely on the fund for payment.⁷ (Emphasis added.)

The Supreme Court reversed the appellate decision which had granted the mechanic's lien claimants access to the balance of the construction loan funds held by the lender. In this case the improvements were not completed and there was no evidence of unjust enrichment of either the lender or the borrower. The claimants were restricted to their right to a lien on the real property as provided in Section 1181 of the Code of Civil Procedure.

Reliance on the Fund

The essential basis of the equitable lien doctrine is the justifiable reliance upon the fund by the lien claimants.⁸

Thus, in *Smith*, the court concluded that the mechanic's lien claimants "must have relied upon . . . the amount to be advanced for building purposes"⁹ in view of the admitted facts that the property itself was subject to both a first deed of trust securing the construction loan and a second deed of trust securing the entire purchase price of the land. The two loans combined were equal or nearly equal to the value of the property in its improved state. Moreover, in *Smith*, the lien claimants demonstrated their reliance by making demands upon the lender.

In *Pacific Ready-Cut Homes*, there was evidence that the lien claimants investigated the owner's credit, checked the encumbrances on the property (which included two deeds of trust in addition to that given for the construction loan), furnished materials only after verifying the fact that a construction began, and continued to furnish materials only after having been assured that any funds remaining upon completion of the structure would be paid to them.

⁷ 61 A.C. 790, 794, 394 P.2d 829, 832, 40 Cal. Rptr. 85, 88 (1964).

⁸ *Smith v. Anglo-California Trust Co.*, 205 Cal. 496, 271 Pac. 898 (1928); *Pacific Ready-Cut Homes v. Title Ins. & Trust Co.*, 216 Cal. 447, 14 P.2d 510 (1932); *Hayward Lumber & Inv. Co. v. Coast Fed. Sav. & Loan Ass'n*, 47 Cal. App. 2d 211, 117 P.2d 682 (1941).

⁹ 205 Cal. 496, 501, 271 Pac. 898, 901-02 (1928).

LIMITATIONS OF THE DOCTRINE

In every discovered case where an equitable lien has been imposed upon funds in the hands of a construction lender, the improvements had been completed and there was, therefore, a sum of money due the borrower.¹⁰ As previously stated, the lien is imposed to prevent either unjust enrichment of the lender or the borrower. Thus, in *Smith*, the court emphasized that "the houses for the construction of which the building loan account was opened have been completed,"¹¹ and accordingly concluded, "it would be inequitable and unjust . . . to permit (the borrower) to withhold, at this time, any part of the fund upon which the lien claimants must surely have relied for reimbursement."¹²

Similarly, in *Ralph C. Sutro Co. v. Paramount Plastering, Inc.*¹³ the court held that the lien claimants were entitled to the loan surplus since "the appellant (lender) has had the benefit of its security, now owns the property and the completed buildings thereon, and seeks to avoid payment therefor. We cannot find that it has any such right."¹⁴ And in *Whiting-Mead Co. v. West Coast etc. Co.*¹⁵ the court observed that the lender had "the right, under the agreement, to have on the property a completed structure . . . thus providing the agreed security for the loan,"¹⁶ but the building having been completed, such funds as remained should be paid the mechanic's lien claimants.

In cases where there is no completed building, the only security the lender has for the undisbursed portion of its full loan commitment is the right to retain the undisbursed funds until it has the security for which it bargained. Depriving the lender of that right does not prevent unjust enrichment, if the cost of completing the improvements is equal to or more than that amount remaining undisbursed in the loan account. The cases hold that in these situations the lender has the right to expend undisbursed funds to complete the buildings securing its loan, and that, notwithstanding this expenditure, the lender is still entitled to its first lien priority over the claims of mechanics and materialmen.¹⁷

¹⁰ Brief for the California Bankers Association as *Amicus Curiae*, p. 10, A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 394 P.2d 829, 40 Cal. Rptr. 85 (1964).

¹¹ *Smith v. Anglo-California Trust Co.*, 205 Cal. 496, 503, 271 Pac. 898, 901 (1928).

¹² *Id.* at 504, 271 Pac. at 901-02.

¹³ 216 Cal. App. 2d 433, 31 Cal. Rptr. 174 (1963).

¹⁴ *Id.* at 438, 31 Cal. Rptr. at 177.

¹⁵ 66 Cal. App. 2d 460, 152 P.2d 629 (1944).

¹⁶ *Id.* at 465, 152 P.2d at 632.

¹⁷ Brief for the California Bankers Association as *Amicus Curiae*, p. 12, A-1

OTHER REMEDIES

In addition to the judicially created doctrine of equitable liens, the labor or material supplier has three remedies available to him to secure the payment for his labor or services, and the remedies are cumulative. These remedies are: a recorded lien upon the property upon which the labor or materials supplier had bestowed labor or furnished materials, Section 1181 of the Code of Civil Procedure; a stop notice served upon the lender or other holder of the construction fund pursuant to Section 1190.1(h) of the Code of Civil Procedure; or a suit in contract against the owner or general contractor.¹⁸

The imposition of an equitable lien has the practical effect of rendering the mortgagee's first lien subordinate to the claims of laborers and materialmen.¹⁹ It is commonly argued by construction lenders and other holders of construction funds that the legislature intended Section 1190.1(h) of the Code of Civil Procedure²⁰ to supplant this doctrine of equitable relief and to engraft procedural and other refinements upon it, in order to give additional protection to all parties concerned.²¹

Both the statute and the equitable lien doctrine deal with the right of a mechanic's lien claimant to subject construction loan funds to the satisfaction of their claims. In each case, the remedy granted supplements the claimants' remedies under the mechanic's lien

Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 394 P.2d 829, 40 Cal. Rptr. 85 (1964), which cites Mortgage Guar. Co. v. Hammond Lumber Co., 13 Cal.App.2d 538, 57 P.2d 164 (1936); Hayward Lumber & Inv. Co. v. Corbett, 138 Cal.App. 644, 33 P.2d 41 (1934); San Mateo Planing Mill Co. v. Davenport Realty Co., 218 Cal. 702, 24 P.2d 787 (1933).

¹⁸ See Comment, 51 CALIF. L. REV. 331, 337 (1963). "Three provisions indicate the property subject to a mechanics' lien: (1) Section 15, Article XX of the California Constitution provides that the constitutional right to lien shall be 'upon the *property* upon which they have bestowed labor or furnished material . . .' (2) Section 1181 provides that the lien shall be 'upon the *property* upon which they have bestowed labor or furnished materials or appliances,' and (3) Section 1183.1(a) provides that the '*land* upon which any building, improvement, well or structure is constructed, together with a convenient space about the same, or so much as may be required for the convenient use and occupation thereof, to be determined by the court on rendering judgment, is *also* subject to the lien. . . .'"

¹⁹ CAL. CODE CIV. PROC. § 1190.1(h). This statutory provision permits a supplier of labor or materials to file a bonded stop notice with the lender or other holder of the construction funds. When the stop notice has been properly filed the lender is prevented, under possible personal liability, from disbursing to anyone an amount equal to eighty per-cent of the bond.

²⁰ Barr Lumber Co. v. Shaffer, 108 Cal.App.2d 14, 238 P.2d 99 (1951). See also Rheem Mfg. Co. v. United States, 57 Cal.2d 621, 371 P.2d 578, 21 Cal. Rptr. 802 (1962).

²¹ Brief for the California Bankers Association as *Amicus Curiae*, pp. 15-18, A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n, 61 A.C. 790, 394 P.2d 829, 40 Cal. Rptr. 85 (1964).

laws.²² Both remedies are dependant upon a loan having been made for the purpose of paying for the costs of construction.²³

The duties imposed upon the lender by Section 1190.1(h) and the equitable lien doctrine are similar. The equitable lien doctrine does not require the lender to take steps to ensure that the funds disbursed by it were applied to pay for labor and materials,²⁴ and the statute does not purport to do so. When properly invoked, both prevent the lender from making further disbursements of money to the borrower or to his general creditors, and the statute, like the doctrine, prohibits the lender who has been fully secured by a completed structure, from applying any surplus funds to reduce the borrower's secured debt to it.²⁵

CONCLUSION

The equitable lien doctrine, if applied within the strict framework as set forth in *Smith* and *Pacific Ready-Cut Homes*, serves to prevent the unjust enrichment of those who are in a position to control the disbursement of construction funds. Any extension of this doctrine would tend to make it generally co-extensive in purpose and effect with Section 1190.1(h). If this should ever occur, an argument could be advanced that the judicially created doctrine cannot co-exist with that enacted by the legislature without emasculating the statutory requirements of notice and bond. Such an argument, if accepted by the courts, would have the effect of merging the equitable doctrine into the statute, thereby preventing the mechanic's lien claimant from perfecting a lien against the construction funds unless he complied with the strict requirements of Section 1190.1(h).

The courts have been prudent in affording equitable relief along with the other remedies available to mechanic's lien claimants. An extension of the doctrine may lead to its destruction. However, when enforced within the requirements established in *Smith* and *Pacific Ready-Cut Homes*, it fills an apparent gap in the protection of innocent parties threatened with harm.

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²² *Hayward Lumber & Inv. Co. v. Coast Fed. Sav. & Loan Ass'n*, 47 Cal. App.2d 211, 117 P.2d 682 (1941) (equitable lien); *Calhoun v. Huntington Park First Sav. & Loan Ass'n*, 186 Cal. App. 2d 451, 9 Cal. Rptr. 479 (1960) (stop notice).

²³ *Compare Smith v. Anglo-California Trust Co.*, 205 Cal. 496, 271 Pac. 898 (1928) with CAL. CODE CIV. PROC. § 1190.1(h).

²⁴ *Smith v. Anglo-California Trust Co.*, 205 Cal. 496, 501-02, 271 Pac. 899, 901 (1928).

²⁵ *Ralph C. Sutro Co. v. Paramount Plastering, Inc.*, 216 Cal.App.2d 433, 31 Cal. Rptr. 174 (1963).