

# Construction Newsletter

[Presented by the Law Offices of Ashley A. Baron]

## Legal News for Construction Industry

### Stop Notices on Private Works

A stop notice on a private works project is a remedy which is designed to freeze funds held by the construction lender and, after a court determination of what is owed, pay them over to the general contractor, subcontractor or material supplier, directly from the bank. Most contractors and suppliers ask: Why bother with a stop notice when I have filed a mechanic's lien? Most owners would prefer to avoid stop notices because they disrupt the draws from their lender.

The mechanic's lien is a lien against the real property and the structures thereon, whereas, the stop notice attaches the bank funds that have been lent by a bank but not drawn on by the owner or developer. Thus, the mechanic's lien and the stop notice attach two different things. The most important reason for the stop notice remedy is that if the project is upside down and more is owed on the project than it is worth, the lender could foreclose on the project and the contractor or material supplier could be stuck with pennies on the dollar if they only have a mechanics' lien against the real property.

A stop notice may be sent to the lender either bonded or unbonded. A bond is nothing more than an insurance policy saying that if the stop notice is found to be invalid the

bonding company will pay any damage claim up to a certain amount. The bond on a stop notice must be for 125 percent of the stop notice claim. If the stop notice is sent to the lender unbonded the lender may, at its discretion, acknowledge it and withhold the funds or refuse to do so. If a stop notice is sent to a lender and it is bonded, the lender must withhold funds under the bonded stop notice.

One of the often overlooked ways of not having to pay for a bond is *Civil Code* § 3096 which provides that the bond be issued by good and sufficient sureties. Thus, sureties on payment bonds may be either two or more sufficient personal sureties or one sufficient admitted surety insurer. *Code of Civil Procedure* §995.310. That means that two principals of the entity that wants to serve the stop notice may agree to act as surety for the bond. Such bonding will save thousands of dollars for the contractor or supplier who wants to serve a stop notice.

The bank may object to the sufficiency of the non-corporate sureties but must do so within 20 days of service of the stop notice and bond. Banks are usually slow to react and often the time expires prior to the objection.

Even if the bank does object, the contractor or supplier may within 10 days of the objection serve a bond

secured by a corporation licensed by the Insurance Commissioner to issue such bonds in California. *Code of Civil Procedure* § 995.120(a).

Owners too may benefit from the stop notice law if they understand it. An owner may make written demand for service of a stop notice from all entities entitled to mechanics' lien remedies. Such demands are often ignored or overlooked by contractors and material suppliers. The failure to respond to such a demand acts as a forfeiture of all stop notice and mechanic's lien rights. *Civil Code* § 3158.

The only hitch is the Civil Code section does not provide a time for when a response must be made by a contractor or material supplier. The *California Mechanics' Liens* 3<sup>rd</sup> Ed. suggests that Civil Code § 3160(b) timeframe governs when the response must be made. See pg. 145 §3.41.

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That interpretation would mean the contractor or supplier must serve the response prior to the time expiring for filing of mechanics' liens.

Such an interpretation does not seem to make sense for two reasons. First, it would provide no benefit for making the demand since the contractor or supplier would have to serve the stop notice by that time regardless of the demand. Further, it would seem contradictory in that if the contractor filed a mechanic's lien but did not respond to the demand for stop notice, then such logic would dictate that the properly and timely filed mechanic's lien was invalidated by the failure to respond to the demand for stop notice.

It could be argued that a response by the contractors and suppliers must be made within a reasonable time after the service of the demand as long as the contractor had completed their portion of the work or supplier supplied all materials to be supplied.

Another distinct difference in what may be awarded on a bonded stop notice as opposed to a mechanics' lien claim is attorney's fees. *Civil Code* § 3176 provides that the prevailing party is entitled to collect, from the party held liable for the claim, reasonable attorney's fees. This is a reciprocal provision so if the owner prevails on the bonded stop notice claim it is entitled to attorney's fees.

Claimants must serve a stop notice under the same time period restrictions that apply to filing mechanics' liens, however, the stop notice is not premature if filed before the contractor ceases work on the project as is so for mechanics' liens.

Savvy owners on larger projects are using multiple contracts instead of one contract. As such under *Civil Code* §3117 the owner may record separate notices of completion when the work is done pursuant to each original contract. Once the owner records a valid notice of completion on any of the contracts the original contractor only has sixty (60) days to record its

mechanics' lien and all claimants under that contract must record their mechanics' liens and serve a stop notice within thirty (30) days. See *Civil Code* § 3160 as to the time frame for stop notices being the same as set forth in *Civil Code* §3117. In this way the owner can determine the exact amount of outstanding payments and what its liability is for each phase of construction. This prevents the original contractor from withholding payment from contractors and suppliers for ups and extras that the owner is unaware exist.

One consequence of the separate mechanics' lien and stop notice remedies is that if an owner, which has both mechanics' liens filed and stop notices served, chooses to bond around them, it is faced with posting two bonds and paying a separate premium for each. The bond for the stop notice is 125% of the amount of the stop notice and the bond for the mechanics' lien is 150% of the amount of the mechanics' lien. The cost of each bond is usually 1-2% of the total amount of each claim. So if the mechanics' liens and stop notices total 10 million each the bond on the stop notices must be for 12.5 million and the mechanics' liens bond must be for 15 million. Thus, the premiums on the stop notice bonds are from 125,000 to 250,000 dollars per year and on the mechanics' lien from 150,000 to 300,000 per year.

Many argue, especially on large project where millions are in question, that the bonds are really duplicative because they both derive from fundamentally the same monies owed and not double the amount. In the above example, the owner is actually being forced to bond 27.5 million when the amount claimed owed is 10 million. As can be seen from the above example the bonding cost can be prohibitive if the owner is cash strapped, paying a law firm for representation, paying for an arbitration service and attempting to complete the project with alternative

contractors so as to dispute the claims being made.

However, because of the way the statutory scheme is set up, there is no authority for a court to reduce the bonds on either the stop notices or the mechanics' liens. It appears that the legislature believed by requiring the contractor to serve a bond with the stop notice on the lender it would discourage contractors from doing so unless they felt the real property securing their mechanics' lien claim was not providing security of one hundred cents on the dollar. However, as set forth herein the ability of the contractor to self bond removes the dissuasion.

One solution possibly for the owner is the same as the contractor, namely the owner can self bond on the stop notice bond under *Civil Code* §3171 for the release of the withheld funds. Arguably, if the lender will accept self bonding by the contractor or supplier, it should do so from the owner as well.

The legislature should rethink this law and revise the statutes so the owner does not have to, in essence, over bond the claims being made. Until then, contractors have a great incentive to both file a mechanics' lien and serve a bonded stop notice.

We now have both Orange County and Park City Offices. Ashley Baron, a U.S.C. undergraduate and law school graduate, has been a lawyer for the past 29 years. Ms Baron has tried over 100 cases. The firm performs construction, business, labor law and litigation support for developers, prime contractors, material suppliers, subcontractors, banks, title companies and other businesses in Orange, Riverside, San Bernardino and Los Angeles Counties. For further information contact us at (714) 974-1400 or e-mail us at [ashleybaronesq@yahoo.com](mailto:ashleybaronesq@yahoo.com). You can now also go to our web site [www.ashleybaron.com](http://www.ashleybaron.com) to read more about our firm or view our most recent newsletters.