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Commercial Transactions

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Commercial Transactions

Commercial Transactions; construction lenders—withholding of funds

Civil Code §§ 3159, 3162 (amended).
AB 3087 (Baca); 1994 STAT. Ch. 782

Under existing law, anyone who furnishes labor, services, material, equipment, or power to a worksite, thereby creating a lien against the property,¹ or others who have a lien against the property² may file a stop notice³ with the construction lender.⁴

Prior law stated that a construction lender was required to withhold funds upon receipt of a bonded stop notice⁵ from the original contractor⁶ where a payment bond⁷ had previously been recorded.⁸ Additionally, under prior law, a

1. See CAL. CIV. CODE § 3110 (West 1993) (listing what persons are entitled to have a lien against property); see also *In re Morrel*, 42 B.R. 973, 979 (Bankr. N.D. Cal. 1984) (holding that where an architect had completed drawings and specifications, but had not commenced any work, he was entitled to a lien against the property); *Myers v. Alta Const. Co.*, 37 Cal. 2d 739, 742, 235 P.2d 1, 2-3 (1951) (holding that all laborers, skilled or unskilled, may be entitled to a lien); *Nolte v. Smith*, 189 Cal. App. 2d 140, 149-50, 11 Cal. Rptr. 261, 267 (1961) (holding that where a civil engineer set permanent monuments for land subdivision and performed extensive engineering services, he was entitled to lien).

2. See CAL. CIV. CODE § 3111 (West 1993) (specifying that a lien exists where an express trust fund is created through a collective bargaining agreement intended to benefit a claimant); *id.* § 3112 (West 1993) (declaring that anyone who improves the land at the instance or request of the owner will have a lien on the property); see also *Thomas v. Gismegian*, 191 Cal. 497, 498, 216 P. 601, 602 (1923) (holding that the grading and levelling of land for irrigation was sufficient to create a lien); *Carpenters Health & Welfare Trust Fund v. Parnas Corp.*, 176 Cal. App. 3d 1196, 1199, 222 Cal. Rptr. 668, 670 (1986) (stating that a lien created by California Civil Code § 3111 places the same obligation on property owners as they would have in respect to unpaid workers, subcontractors, or materialmen); *California Portland Cement Co. v. Wentworth Hotel Co.*, 16 Cal. App. 692, 707, 118 P. 103, 109 (1911) (stating that the planting and caring of seeds, trees and shrubs constitutes improvements on the land and is sufficient to create a lien).

3. See BLACK'S LAW DICTIONARY 1420 (6th ed. 1990) (defining stop notice statutes as a remedy whereby a contractor can make a claim against a construction lender for the undisbursed proceeds of a construction loan); see also CAL. CIV. CODE § 3103 (West 1993) (setting forth the content requirements of a stop notice). See generally Rodney Moss, *The Stop Notice Remedy in California—Updated*, 47 L.A. B. BULL. 299 (1972) (discussing a contractor's stop notice remedy).

4. CAL. CIV. CODE § 3159(a) (amended by Chapter 782); see *id.* § 3087 (West 1993) (defining construction lender).

5. See *id.* § 3083 (West 1993) (defining a bonded stop notice as a stop notice accompanied by a sum of 1.25% times the stop notice claim); see also ASSEMBLY JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF AB 3087, at 2 (May 11, 1994) (stating that the purpose of a bonded stop notice is to prevent damages to the lender if the claim is meritless).

6. See CAL. CIV. CODE § 3095 (West 1993) (defining original contractor as a contractor in direct relationship with the owner); see also *Scott, Blake & Wynne v. Summit Ridge Estates, Inc.*, 251 Cal. App. 2d 347, 353, 59 Cal. Rptr. 587, 591 (1967) (holding that (1) A contractor has a direct contract with the owner; and (2) the owner will be estopped from denying that improvements were done at his request, if the owner has actual knowledge of the work being performed and does not exempt himself from liability); *cf.* CAL. CIV. CODE § 3104 (West 1993) (defining subcontractor as any contractor with no direct contractual relationship with the owner).

7. See CAL. CIV. CODE § 3096 (West 1993) (defining payment bond); see also 40 U.S.C.A. 270a(a)(2) (West 1986) (setting forth payment bond requirements for contractors of public buildings or works).

construction lender was allowed, at its option, to withhold or elect not to withhold funds pursuant to a stop notice or bonded stop notice from anyone other than the original contractor.⁹ Prior law additionally provided that a construction lender could choose not to withhold funds pursuant to a bonded stop notice where a payment bond had been previously recorded.¹⁰

Chapter 782 adds to existing law by requiring a construction lender to always withhold funds upon receipt of a stop notice or a bonded stop notice from an original contractor, regardless of whether a payment bond had been previously recorded.¹¹ Additionally, a construction lender must withhold funds pursuant to a bonded stop notice filed by other persons having a lien against the property,¹² unless a payment bond had been previously recorded.¹³ If a payment bond had previously been recorded, Chapter 782 allows a construction lender to exercise its option not to withhold only in the case of a stop notice or bonded stop notice given by anyone other than the original contractor.¹⁴ However, Chapter 782 declares that in no event is a lender required to withhold more than the net amount due the original contractor or subcontractor less any deductions for bonded stop notice claims filed by all subcontractors or material suppliers.¹⁵

INTERPRETIVE COMMENT

Chapter 782 is intended to eliminate the ambiguity in the law of when a lender must withhold funds in the event that an original contractor files a bonded stop notice.¹⁶ Additionally, by adding a limit to the amount required to be withheld, lenders will be protected from withholding twice or more for the same claim.¹⁷

8. 1988 Cal. Stat. ch. 1627, sec. 2, at 5932-33 (amending CAL. CIV. CODE § 3159); *id.*, sec. 4, at 5933-34 (amending CAL. CIV. CODE § 3162); *see* CAL. CIV. CODE § 3235 (West 1993) (setting forth the procedures for recording a payment bond); *Rossmann Mill & Lumber Co. v. Fullerton Sav. & Loan Ass'n*, 221 Cal. App. 2d 705, 709, 34 Cal. Rptr. 644, 647 (1963) (stating that the purpose of a stop notice is to protect those persons who furnish labor and material).

9. 1988 Cal. Stat. ch. 1627, sec. 2, at 5932-33 (amending CAL. CIV. CODE § 3159); *id.*, sec. 4, at 5933-34 (amending CAL. CIV. CODE § 3162).

10. *Id.*; *see* ASSEMBLY JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF AB 3087, at 1-2 (May 11, 1994) (recognizing that "the second and third sentences of [California] Civil Code [§] 3159 are in direct conflict," and that the same conflict exists in California Civil Code § 3162).

11. CAL. CIV. CODE §§ 3159(a)(1), 3162(a)(1) (amended by Chapter 782).

12. *See id.* §§ 3159(a)(2), 3162(a)(2) (allowing persons named in California Civil Code §§ 3110, 3111 and 3112 to file a bonded stop notice against a construction lender).

13. *Id.*

14. *Id.*; *see id.* (permitting a construction lender to elect not to withhold funds for a stop notice or bonded stop notice filed by anyone other than the original contractor if a payment bond has been previously recorded). *See generally New Bills*, THE RECORDER, Feb. 25, 1994, at 14 (summarizing AB 3087).

15. CAL. CIV. CODE §§ 3159(3)(b)-(c), 3162(3)(b)-(c) (amended by Chapter 782).

16. ASSEMBLY JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF AB 3087, at 1-2 (May 11, 1994).

17. *Id.* at 2; *see id.* (commenting on AB 3087 in regard to limiting a lender's liability and discussing the concerns of double withholding by providing an example of how it might occur); *see also* CAL. CIV. CODE §§ 3159(3)(b)-(c), 3162(3)(b)-(c) (amended by Chapter 782) (limiting the amount a lender must withhold). Double withholding could occur under the following scenario: A subcontractor files a bonded stop notice and the lender withholds and, subsequently, the general contractor files a bonded stop notice including the amount

Construction lenders are further protected because the lender is required to withhold only when the original contractor files a bonded stop notice.¹⁸

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Commercial Transactions; letters of credit

Civil Code § 2787 (amended); Code of Civil Procedure §§ 580.5, 580.7 (new); Commercial Code § 5114 (amended).
SB 1612 (Kopp); 1994 STAT. Ch. 611
(Effective September 15, 1994)

Under prior law, a letter of credit¹ was considered a form of suretyship obligation.² Consequently, when a lender initiated a nonjudicial foreclosure, a surety or guarantor was prohibited from taking a deficiency judgment.³ Under

owed to the subcontractor by the general contractor. ASSEMBLY JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF AB 3087, at 2 (May 11, 1994). Without the provision limiting the amount to be withheld, the lender would be required to double withhold and possibly exhaust the loan account and endanger the lender's security interest. *Id.*

18. CAL. CIV. CODE §§ 3159(a), 3162(a) (amended by Chapter 782).

1. See CAL. COM. CODE § 5103(a) (West 1964) (defining letter of credit as an engagement by a bank or other person made at the request of a customer that the bank will honor certain drafts or other demands of payment made in compliance with the terms of the credit); see also *Continental Nat'l Bank v. National City Bank*, 69 F.2d 312, 316 (9th Cir. 1934) (stating that one of the main functions of a letter of credit is to substitute a bank's credit for the buyer's credit); *Western Sec. Bank v. Superior Court*, 21 Cal. App. 4th 156, 173, 25 Cal. Rptr. 2d 908, 917 (1993) (defining a traditional letter of credit as a credit used to finance the sale of goods, and a standby letter of credit as a guarantee device if the customer defaults on a loan), review granted, 871 P.2d 203, 29 Cal. Rptr. 2d 151 (1994); cf. U.C.C. § 5-103(1)(a) (1993) (defining letters of credit). See generally Peter R. Jarvis, *Standby Letters of Credit—Issuers' Subrogation and Assignment Rights—Part I*, 9 UCC L.J. 356, 356-63 (1976) (defining and discussing sales and standby letters of credit); Neil J. Rubenstein, *The Issuer's Rights and Obligations Under a Letter of Credit*, 17 UCC L.J. 129, 142-74 (1984) (discussing the substantive aspects of a letter of credit).

2. 1939 Cal. Stat. ch. 453, sec. 10, at 1796-97 (amending CAL. CIV. CODE § 2787); see *id.* (stating that guaranties of collection or continuing guaranties are forms of suretyship obligation); see also CAL. CIV. CODE § 2787 (amended by Chapter 611) (defining surety and guarantor as one who promises to answer for the debt, default, or miscarriage of another or hypothecates property as security); *Matthews v. Hinton*, 234 Cal. App. 3d 736, 740, 44 Cal. Rptr. 692, 695 (1965) (stating that a suretyship is created when two persons are obligated to one creditor with one being ultimately liable).

3. CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 1994); see CAL. CIV. CODE § 2924 (West 1993 & Supp. 1994) (stating that the mortgagee or trustee has a power of sale that can be exercised upon breach of the mortgage agreement); CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 1994) (stating that a deficiency judgment cannot be sought after a sale by a mortgagee or trustee under power of sale contained in the mortgage or deed of trust); *Western Sec. Bank*, 21 Cal. App. 4th at 169, 25 Cal. Rptr. 2d at 913-14 (stating that a lender cannot seek a deficiency judgment after a nonjudicial foreclosure); *id.* at 178, 25 Cal. Rptr. 2d at 920 (holding that a lender who held letters of credit could not recover on the letters after a nonjudicial foreclosure was initiated that left a deficiency on the amount owed by the debtor); see also *United States v. Haddon Hacienda Co.*, 541 F.2d 777, 782 (1976) (stating that the purpose of antideficiency laws is to keep judicial and

existing law, the "one action rule" stipulates that the only remedy for a mortgagee or trustee is foreclosure.⁴ Therefore, under prior law, a mortgagee or trustee was prohibited from collecting on a letter of credit, which was a form of suretyship, once a nonjudicial foreclosure was brought.⁵ Existing law also provides that absent fraud or forgery, an issuer must honor a draft or demand for payment.⁶

Chapter 611 provides that a letter of credit is no longer a form of suretyship.⁷ Additionally, Chapter 611 adds to existing law by expressly mandating that the presentment, receipt of or demand for payment, enforcement, payment, or reimbursement of a letter of credit before or after a judicial or nonjudicial foreclosure does not violate the one action rule or the antideficiency statute.⁸ Chapter 611 also states that a letter of credit issued after the effective date of Chapter 611 will not be enforceable if it was issued to avoid default of a loan secured by a deed of trust or mortgage.⁹

INTERPRETIVE COMMENT

The use of letters of credit is popular in many national and international transactions.¹⁰ Typically, a financial institution, usually a bank, will issue the letter of credit to a customer whereby the bank will then pay money to a third person upon compliance with the terms of the credit. For example, a letter of credit might require that compliance be evidenced by presentation of documents proving that certain goods have been shipped or that certain property has been transferred to the customer. The customer then assumes responsibility for the amount of money disbursed by the issuer of the letter of credit to the third party.¹¹

nonjudicial foreclosures in parity); BLACK'S LAW DICTIONARY 422 (6th ed. 1990) (defining deficiency judgment as the imposition of personal liability on the mortgagor for the unpaid balance of a debt after a foreclosure sale has failed to yield the full amount of the debt). See generally Barbara B. Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes*, 17 UCLA L. REV. 245, 245-338 (1969) (discussing California's antideficiency laws).

4. CAL. CIV. PROC. CODE § 726 (West 1980 & Supp. 1994); *Pajaro Dunes Rental Agency v. Spitters*, 142 B.R. 383, 385 (Bankr. N.D. Cal. 1992) (stating that the sole form of action for a debt secured by a mortgage or deed of trust is foreclosure), *aff'd*, 156 B.R. 163 (1993).

5. 1939 Cal. Stat. ch. 453, sec. 10, at 1796-97 (amending CAL. CIV. CODE § 2787); see *Western Sec. Bank*, 21 Cal. App. 4th at 178, 25 Cal. Rptr. 2d at 920; see also SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 4-5 (May 17, 1994) (discussing *Western Security Bank* and the conflicts in the prior law).

6. CAL. COM. CODE § 5114(2)(a) (amended by Chapter 611); see *id.* § 5103(1)(a) (West 1964) (stating that letters of credit are considered drafts or demands for payment); see also SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 3 (May 17, 1994) (stating that the provisions set out in California Commercial Code § 5114 are known as the "independence principle"); cf. U.C.C. § 5-114(1) (1993) (requiring an issuer to honor a draft or demand for payment).

7. CAL. CIV. CODE § 2787 (amended by Chapter 611).

8. CAL. CIV. PROC. CODE § 580.5(b)(1)-(3) (enacted by Chapter 611). *Contra Western Sec. Bank*, 21 Cal. App. 4th at 178, 25 Cal. Rptr. 2d at 920 (1993).

9. CAL. CIV. PROC. CODE § 580.7(b)(1)-(4) (enacted by Chapter 611).

10. ASSEMBLY FLOOR, COMMITTEE ANALYSIS OF SB 1612, at 2 (July 7, 1994).

11. See generally 50 AM. JUR. 2D, *Letters of Credit, etc.* § 1 (1970) (discussing transactions involving a letter of credit).

Chapter 611 was enacted to overrule *Western Security Bank v. Superior Court*,¹² which held that a letter of credit presented to the issuer after the lender's nonjudicial foreclosure of a loan secured by real property was unenforceable.¹³

However, Chapter 611 may be unnecessary, as a lender holding letters of credit may have other options to avoid unfavorable results.¹⁴ Such options include initiating a judicial foreclosure, by which a lender would not be burdened by the antideficiency statute.¹⁵ Nonetheless, this could be disfavored by lenders because of the extra time and expense required.¹⁶ Another option for the lender would be to collect on the letters of credit and subrogate¹⁷ its rights to foreclose to the issuer of the letters, thereby not violating the one action rule.¹⁸

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12. 21 Cal. App. 4th 156, 25 Cal. Rptr. 2d 908 (1993).

13. *Western Sec. Bank*, 21 Cal. App. 4th at 178, 25 Cal. Rptr. 2d at 920; see 1994 Cal. Stat. ch. 611, sec. 5, at 2535 (stating that the Legislature intends to abrogate the holding of *Western Security Bank*); SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 2-5 (May 17, 1994) (stating that Chapter 611 is intended to overrule *Western Security Bank*).

14. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 5 (May 17, 1994).

15. *Id.*; see CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 1994) (prohibiting a deficiency judgment after a nonjudicial foreclosure sale); see also *Pajaro Dunes Rental Agency v. Spitters*, 156 B.R. 263, 266 (Bankr. N.D. Cal. 1993) (permitting a foreclosure and a deficiency judgment to be brought in a single action).

16. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 5 (May 17, 1994).

17. See BLACK'S LAW DICTIONARY 1427 (6th ed. 1990) (defining subrogation as the substitution of one person for another in reference to a legal claim).

18. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 1612, at 5 (May 17, 1994).

