Mechanics' Liens: The "Stop Notice" Comes to Washington

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Washington's mechanics' lien laws were changed in two significant respects by the legislature in its 1973 First Extraordinary Session. The new Act, only the fifth significant amendment to these laws since their enactment in 1854, has two parts. The first, Section 2, allows a potential mechanics' lien claimant (hereinafter a PLC) to assert a priority against construction loan funds disbursed by the construction lender after the PLC has notified the lender of his unpaid bill. To assuage lenders, who naturally made vocal objection to this Section 2 priority, Section 3 makes a change in mortgage priorities long desired by construction lenders; eliminating the rule of Elmendorf-Anthony v. Dunn, Section 3 gives any future advances under a mortgage or deed of trust priority over any encumbrance attaching to the property subsequent to the recording of the mortgage, "regardless of when the same [advances] are disbursed, or whether such disbursements are obligatory."
The desirability of these changes is clear. Reliance on the traditional mechanics' lien to satisfy unpaid bills has often been a frustrating and disappointing experience for the PLC. A lender has always been careful to record his construction loan mortgage before any work begins on the project, making the mechanics' lien junior to the mortgage. Furthermore, foreclosing a mechanics' lien is an expensive and time-consuming procedure.7 By allowing a PLC the additional remedy of a qualified priority to the construction loan funds, the legislature hoped that the PLC's bills would go unpaid less often.8 Section 3, as well as being a concession to lending interests displeased at the prospect of having to withhold loan funds for unpaid PLC's in order to continue "draws" for completion of the project, makes the mortgage lender better able to predict the priority of future advances under his mortgage.9

This note will discuss both the PLC's new remedy and the new priority given to mortgages for future advances. Both provisions will make present construction industry practices more equitable: Section 2 has given PLC's a new, productive and efficient remedy, designed to work with and improve the traditional real property lien, and Section 3 has repaired the damage done to lenders' mortgage priorities by a recent Washington case.10 Both Sections do create new problems of their own, however, which are also discussed.

I. OPTIONAL FUTURE ADVANCES VERSUS INTERVENING ENCUMBRANCES

_Gordon v. Graham_,11 the first case to fix priorities between a mortgage for future advances and a subsequent mortgage,12 gave absolute priority to the first mortgagee. Though the first mortgagee was under no obligation to make the advances, and had notice of the second mortgagee, "it was the Folly of the second Mortgagee, with Notice, to

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7. See note 52 and accompanying text infra.
8. See note 53 infra.
12. 3 G. Glenn, Mortages § 401 at 1608 (1943).
take such Security." American cases giving the prior mortgage for future optional advances priority over intervening encumbrances follow the reasoning of Gordon; i.e., that record notice to the junior encumbrancer puts him upon inquiry as to the state of dealings between the parties to the first mortgage, and if that record reveals a contract for optional future advances, he cannot later complain, for he had notice of this superior claim before dealing with the mortgagor. Although several states give optional future advances a statutory priority, Texas appears to be the only state still adhering to Gordon by judicial decision.

14. The clearest and most frequently cited exposition of the minority American view is stated in Witzinski v. Everman, 51 Miss. 841, 846-47 (1876), overruled in North v. McClintock, 208 Miss. 289, 44 So. 2d 412 (1950):
A mortgage to secure future advances, which on its face gives information as to the extent and purpose of the contract, so that a purchaser or junior creditor may, by an inspection of the record, and by ordinary diligence and common prudence, ascertain the extent of the incumbrance, will prevail over the supervening claim of such purchaser or creditor as to all advances made by the mortgagee within the terms of such mortgage, whether made before or after the claim of such purchaser or creditor arose . . . . The law requires mortgages to be recorded for the protection of creditors and purchasers. When recorded, a mortgage is notice of its contents. If it gives information that it is to stand as security for all future indebtedness to accrue from the mortgagor to the mortgagee, a person examining the record is put upon inquiry as to the state of dealings between the parties, and the amount of indebtedness covered by the mortgage, and is duly advised of the right of the mortgagee by the terms of the mortgage to hold the mortgaged property as security to him for such indebtedness as may accrue to him. Thus informed, it is the folly of any one to buy the mortgaged property, or take a mortgage on it or give credit on it, and if he does so, his claim must be subordinated to the paramount right of the senior mortgagee, who in thus securing himself by mortgage, and filing it for record, as required by law, has advertised the world of his paramount claim on the property covered by his mortgage, and is entitled to advance money and extend credit according to the terms of his contract made with the mortgagor, who cannot complain, for such is his contract; and third persons afterwards dealing with him, cannot be heard to complain, for they are affected with full notice, by the record, of what has been agreed on by the mortgagor and mortgagee.


16. Freiberg v. Magale, 70 Tex. 56, 7 S.W. 684 (1888); A.J. Wood v. Parker Square State Bank, 400 S.W. 2d 898, 900 (Tex. 1966). See Jones, Mortgages Secur-
The great majority of American courts do not follow Gordon, and, while giving priority to obligatory advances by the prior mortgagee, subordinate any optional advances to intervening encumbrances of which the prior mortgagee has notice. Professor Osborne isolates four reasons cited by courts for cutting off the priority of "optional" advances: (1) Because the mortgagee makes advances only voluntarily, rather than a single lien arising for all the advances at the time the mortgage is recorded, a separate lien attaches at, and dates from, the time each advance is made; (2) a mortgagee who is under no duty to make advances should not be able to prejudice the security of a subsequent encumbrancer; (3) unless subsequent lienors are given priority against the possibility of later optional advances, the mortgagor in effect perpetrates a fraud against them; (4) courts have a desire to keep the mortgagor's title free for additional mortgages by others, or for sale.
The Washington court joined this majority when it held in *Elmendorf-Anthony v. Dunn*\(^23\) that optional advances should be subordinate to intervening liens, simply because the court found this rule has "the support of the almost universal weight of authority."\(^24\) *Elmendorf* defined an optional advance as one which is "voluntarily made" by the mortgagee;\(^25\) an "obligatory" advance was described in *Cedar v. W.E. Roche Fruit Co.*\(^26\) as an advance the mortgagee is "contractually bound to make"\(^27\) or one "essential to his own security."\(^28\)

Section 3 has in effect overruled these cases, returning to the *Gordon* rule by giving optional advances protection against subsequent encumbrances, especially mechanics' liens.\(^29\) Why this break from "almost universal authority"? There are three reasons: First, *Gordon* has always been a much more desirable rule to mortgage lenders and their title insurers who understandably do not like to gamble that the security for their advances will not be encumbered by intervening mechanics' liens. Second, the increased security given construction loan mortgages makes investment in Washington construction more attractive. The third and perhaps most immediate cause for legislative approval of Section 3 was that while the legislature was...
holding hearings on the proposed act, the Washington Supreme Court reaffirmed in form but substantially changed in spirit the rule of Elmendorf-Anthony. In *National Bank of Washington v. Equity Investors* (hereinafter cited by its common name, *Columbia Wood Products*)\(^{30}\) the court found a typical construction loan agreement to be one for optional advances for the purpose of assigning priorities between it and an intervening mechanics' lien,\(^{31}\) even though by the *W. E. Roche* definition of "obligate" the agreement certainly did obligate the mortgagee to make the advances.

Gilmore calls the distinction between optional and obligatory advances "nonsensical": \(^{32}\) "There are few, if any, future advance clauses which an astute judge cannot, at will, classify on one side or the other of the line between obligatory and voluntary."\(^{33}\) The *Columbia Wood Products* decision lends credence to Gilmore's theory. The court found that a construction loan mortgage providing as conditions precedent to the mortgagee's duty to make advances the approval of an architect as to job progress and the requirement that all work be done "in a good and workmanlike manner," and reserving for the mortgagee the right to make advances "at such time and in such amounts as the Lender shall determine,"\(^ {34}\) gave the mortgagee such broad discretionary powers that the mortgage would be classified as one for optional rather than mandatory future advances for the purpose of determining its priority relative to appellant's mechanics' lien.\(^ {35}\)

The court observed that had it been asked by the borrower to compel an advance, these conditions to the mortgagee's duty to make an advance would have presented "nearly insuperable obstacles at law."\(^ {36}\) The court's reasoning is unpersuasive. If the conditions precedent, such as progress reports and architect's approval, had been met by the borrower, fulfillment of the remaining condition of personal satisfaction with the quality of the work would have been determined by deciding whether a "reasonable man" would have been satisfied, since the contract was one for construction to specifications.\(^ {37}\)

\(^{31}\) *Id.* at 890, 506 P.2d at 24.
\(^{32}\) Gilmore, *supra* note 19, § 35.4.
\(^{33}\) *Id.*
\(^{34}\) 81 Wn. 2d at 897–98, 506 P.2d at 28 (emphasis omitted).
\(^{35}\) *Id.* at 890, 506 P.2d at 24.
\(^{36}\) *Id.* at 898–99, 506 P.2d at 24.
A finding that the lender reserved a true option to advance the funds at his pleasure was not justified by the expectations or understanding of the parties nor by the document itself; the written contract imposed an obligation to loan the entire amount and a specified schedule for advances based upon the stage of construction.\textsuperscript{38}

In expanding the scope of "optional" advances for the purpose of assigning lien priorities to include other than truly voluntary advances,\textsuperscript{39} the court has left by the wayside the very understandable and workable \textit{Elmendorf} rule,\textsuperscript{40} leaving to speculation the form a con-
struction loan agreement would have to take in the future to insure the priority of future advances made under it.

Perhaps *Columbia Wood Products* would not have been so hard on construction lenders if typical construction loan agreements did, in fact, give the lender substantially less discretion over the disbursement of funds than the one drawn up by the lender in that case. But while the bank might have made clearer its obligation to make each advance the agreement, nevertheless, was not atypical, and parties to such agreements certainly believe they are obligated. *Columbia Wood Products*, if left in effect by the legislature, would have created great difficulties for the construction lender. To assure himself of the priority of his security, he would have had to exercise such careful and complete supervision over the project that it might have made more economic sense for him to have lent his money elsewhere.  

Section 3, however, relieves the lender of having to guess at the priority of his advances under the *Columbia Wood Products* holding. This certainty is not unmerited. The construction lender performs a service at least as valuable as that of the subcontractors. The task of

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41. Chase Manhattan Bank's "form" Building Loan Agreement contains several conditions precedent to the lender's obligation to make advances, such as the lender's receipt of title and other insurance policies and approval by the lender's architect of improvements made and to be made with respect to the plans and also gives the lender the right to exercise "absolute discretion" in establishing "to its satisfaction" the existence or nonexistence of facts critical to this obligation. *Practicing Law Institute, Real Estate Construction* 203-27 (1969).

42. "[A] construction money loan made on the basis of optional advances dilutes the security to the point that it becomes more of a general credit signature loan, than a mortgage transaction." Spradling, *Legal Hazards of Construction Lending*, 19 Bus. Law. 221, 223 (1963).

43. Of course, even under § 3 the lender or his title insurer must still make a physical inspection of the building site, for if the mortgage is not recorded prior to the commencement of construction some of the mortgage's priority is already lost. A subcontractor, whose lien attaches when he begins his work on the site, retains priority over subsequently recorded mortgages. Wash. Rev. Code § 60.04.050 (1963).

44. The importance of the lender is recognized in states where mechanics' liens lose their priority with respect to the improvement when the loan money is actually
balancing interests in each construction project—those of the lender, contractor, owner-borrower, subcontractors and title insurer—is much more a practical problem than a strictly legal one. The construction industry depends on the lender for financing, but he will not provide it unless he can be given assurance, by a title policy or otherwise, that he will not be deprived of the security of his loan by subsequent lien claimants. Unfortunately, neither the one hundred-year-old mechanics’ lien law, nor the priorities established in *Elmendorf-Anthony* or *Columbia Wood Products* show much concern for these business realities.

Osborne suggests that the policy motivating courts to subordinate optional advances to subsequent liens is the desire to keep the mortgagor’s property free for alienation or encumbrance by a second mortgagee or lien claimant. Does Section 3, by erasing the distinction between obligatory and optional advances, violate this policy? Section 3 should have, in fact, no adverse effect on the availability of second mortgages, since the second mortgagee ought to be able to obtain an agreement from the first mortgagee that the first mortgagee will make no further advances except for taxes, insurance or repairs necessary to preserve the security. It has been suggested that the second mort-


45. The pre-ch. 47 title insurance policy secured by the lender guaranteed that the construction loan mortgage had priority as of its recording, but did not guarantee the priority of later advances under the mortgage against intervening mechanics’ liens. Interview with Frank Soderling, Vice President, Security Title Insurance Company, in Seattle, Nov. 6, 1973. In spite of this limited protection, title companies suffered their biggest losses from insuring construction mortgages against mechanics’ liens. Minutes of Washington State Legislature House of Representatives Judiciary Comm. Hearing on S.H.B. 264, 1st Extra. Sess., Feb. 7, 1973.

46. To insure that all potential mechanics’ lienors are paid by the owner or general contractor, the lender uses progress payment systems, job certification systems, “voucher” or “joint check” systems, but they are fallible and are another cost added to construction. See R. Kratovil, *Modern Mortgage Law and Practice* § 214–17 (1972).

47. For example, the court in *Columbia Wood Products*, though admitting that the mortgagee-lender’s building loan agreement is “sound banking practice,” still finds that the agreement’s conditions operated “in law” to subordinate the lender’s first-recorded lien to the appellant’s mechanics’ lien. 81 Wn. 2d at 896, 506 P.2d at 28.

48. See note 22 supra.

49. Montana, a state which also gives optional advances priority, provides a simple solution, a statutory procedure whereby a mortgagor may record an agreement with the first mortgagee that no further optional advances will be made under the first mortgage. *Mont. Rev. Codes Ann.* § 52-201 (1961). Such a subordination agreement may be recorded in Washington. See *Wash. Rev. Code* § 65.08.060 (1963); Richards v. Lawing, 175 Wash. 544, 27 P.2d 730 (1933).
gagee should have no trouble obtaining such an agreement from the first mortgagee.\textsuperscript{50}

The mechanics' lien was an unsatisfactory remedy before the new act\textsuperscript{51} and is made even less valuable by Section 3; no mechanics' lienor relying solely on his real property lien will get a priority over advances given under a prior recorded mortgage, as did the appellants in Columbia Wood Products. He will have to take whatever equity remains in the property after a prior mortgage or deed of trust is fully satisfied. Section 2, however, provides the PLC with a new, independent and cumulative remedy—a priority to certain construction loan funds disbursed by the construction lender after the lender receives notice of the PLC's claim.

II. THE "STOP NOTICE" COMES TO WASHINGTON

A mechanics' lien provides especially poor protection for a subcontractor with a smaller claim; not only is his lien usually junior to a first recorded construction mortgage, but the time and expense needed to perfect the lien are not justified by the amount of the unpaid bill.\textsuperscript{52} Section 2 of the Act responds directly to this unsatisfactory state of affairs\textsuperscript{53} by providing the potential mechanics' lien claimant (PLC)\textsuperscript{54}

\textsuperscript{50} Interview with Eric Pucher, Vice President and Assistant General Counsel, Firstbank Mortgage Corporation, in Seattle, Sept. 5, 1973. The first mortgagee in this situation should not object to discontinuing further advances; once the project is finished, the first mortgagee's funding is normally at an end.

\textsuperscript{51} See text accompanying note 52 infra.

\textsuperscript{52} More Mechanics' Liens remain unfiled than are filed, all by reason of the fact that the party with the inchoate right to file the lien says to himself, "Oh, what's the use? The lien is of no value . . . I am with a lien right sitting behind a trust deed to which the legislature has seen fit to give priority over the lien right. There are numerous other lien claimants. The building is incomplete. The holder of the trust deed is about to foreclose it unless I consent to a ten cent on the dollar settlement. I am going to have to hire a lawyer in order to foreclose my lien and I will probably get wiped out by the trust deed."


\textsuperscript{53} Ch. 47, § 2, WASH. REV. CODE § 60.04.210 (Supp. 1973). "The bill meets the need for some procedure assuring that mechanics' [sic] and materialmen will not to be left with meaningless liens . . . ." REPORT TO THE SPEAKERS OFFICE ON H.B. 264.

\textsuperscript{54} "Potential lien claimant" means any person or entity entitled to assert lien rights pursuant to this chapter [WASH. REV. CODE ch. 60.04 (1963)] and has otherwise complied with the provisions of this chapter and the requirements of chapter 18.27 RCW if required by the provisions thereof." Ch. 47, § 1(4), WASH. REV. CODE § 60.04.200(4) (Supp. 1973). A general contractor may use the stop notice, then, because he is entitled to a mechanics' lien under WASH. REV. CODE § 60.04.110 (1963).
Mechanics' Liens

on a private\textsuperscript{55} and unbonded\textsuperscript{56} construction project with a priority on certain construction loan funds\textsuperscript{57} disbursed by the lender after notice from the PLC of an unpaid bill. The new priority may be claimed by serving a notice of claim—a stop notice—on the construction lender when a payment on the PLC’s purchase order or contract is more than twenty days overdue.\textsuperscript{58} Section 2 also opens a new line of communication between lender and subcontractors, with the hope of “red flagging” nonpayment of subcontractors and exposing potential mechanics’ liens early in the project.\textsuperscript{59}

A number of states have adopted the statutory device of “stop notice,”\textsuperscript{60} granting the potential mechanics’ lienor what is in effect a garnishment of construction loan funds held by the lender or owner.\textsuperscript{61} This, however, is not the effect of the Section 2 stop notice in Washington, because the lender need not withhold any loan funds in response to the stop notice unless he so elects. When the lender receives a stop notice he is given, in effect, three options. First, if the lender

\textsuperscript{55} Ch. 47 [1973] Wash. Laws, supplements WASH. REV. CODE ch. 60.04 (1963) which covers private projects only.

\textsuperscript{56} If a lender obtains a payment bond for at least 50% of the financing, the § 2 priority to certain construction loan funds is not available to the potential lien claimant if he’s covered under the bond. See discussion of bonding accompanying notes 83–88 infra.

\textsuperscript{57} The construction loan fund which is the target of the § 2 priority is the loan fund established between the lender and the borrower, a fund to be used solely for the contemplated project and to be disbursed piecemeal in draws by the lender to the general contractor as progress is made on the project. Loan funds to acquire real property, to acquire personal property not subject to a mechanics’ lien and to pay specified costs and fees are unaffected by § 2. See ch. 47, § 1(2), WASH. REV. CODE § 60.04.200(2) (Supp. 1973).

\textsuperscript{58} Ch. 47, § 2(2)–(4), WASH. REV. CODE § 60.04.210(2)–(4) (Supp. 1973).


\textsuperscript{60} California, for example, has an extensive statutory scheme for stop notices on private projects. CAL. CIV. CODE §§ 3156–72 (West Supp. 1973). See also ALA. CODE tit. 33, § 37 (1959); IND. ANN. STAT § 32-8-3-9 (1973); MISS. CODE ANN. § 85-7-181 (1973); N.C. GEN. STAT. § 44A-18 (Supp. 1971); N.J. REV. STAT. §§ 2A: 44-77, 78 (1951); TEXAS CIV. STAT. ANN. § 5463 (Vernon Supp. 1972–73). A Washington mechanics’ lien statute similar in principle is WASH. REV. CODE § 60.04.110 (1963), which allows the owner to withhold funds from the contractor if mechanics’ liens are filed.

\textsuperscript{61} While this right is usually conferred by the same statutes which provide for mechanics’ liens and is termed a “lien,” the remedy provided is really more in the nature of an equitable garnishment, or, as frequently stated, the notice to the owner has the effect of working an assignment pro tanto of that which is due or to become due from the owner to the contractor from the time of the service of such notice. The remedy is distinct and disconnected from, and additional to, the remedy by lien on the land and building. . . .

chooses to allow further draws upon the construction loan fund, he "shall withhold" funds to satisfy the stop notice from these "next and subsequent draws." 62 Second, if the lender chooses to continue draws without withholding funds for the stop notice, he suffers the "penalty" of Section 2(6), and his mortgage is subordinated to the subsequent mechanics' lien of the stop notice claimant "to the extent of the interim or construction financing wrongfully disbursed, but in no event in an amount greater than the sums ultimately determined to be due the potential lien claimant by a court of competent jurisdiction, or more than the sum stated in the notice, whichever is less." 63 Third, the lender may avoid the effect of the stop notice altogether by making no further loan advances and foreclosing his mortgage. In this last situation, the PLC's only recourse is to his mechanics' lien which will have no enhanced priority by reason of the stop notice.

The first option, paying the PLC's stop notice claim is the most desirable notice to the lender for two reasons: (1) The amount of a stop notice claim is limited to payments due the PLC during a twenty day period. Therefore, in almost all cases the stop notice claim will be for one contract payment only. Thus, the lender will have to withhold only a relatively small amount for the stop notice. (2) Neither of the other two options open to the lender would normally be desirable. The lender does not want the PLC's mechanics' lien put ahead of his mortgage, nor will he want to foreclose his mortgage if the project is unfinished.

How does a PLC make use of the notice of claim remedy, or "stop notice" as it's called in other states? 64 To perfect a stop notice the Act requires that the PLC both maintain his right to a mechanics' lien under R.C.W. ch. 60.04 65 and properly file the special notice of claim to loan funds. A proper filing of the notice of claim requires that within twenty days after a payment is twenty days overdue on his contract or purchase order, a PLC must give notice 66 to the lender 67 of

64. The same remedy is called "stop notice" in California, CAL. CIV. CODE §§ 3156–72 (West Supp. 1973); and elsewhere. 57 C.J.S. Mechanics' Liens § 114 (1948).
66. The PLC's notice to the lender must include:
   (1) A statement that the claimant has furnished labor, materials or equipment for

696
Mechanics' Liens

the sums due and to become due, for which he is entitled to a mechanics' lien under R.C.W. ch. 60.04. When the lender receives the notice he may withhold from next and subsequent draws made on the construction loan fund an amount for the claimant, as determined by the formula in Section 2(4), based on the percentage of the completed work attributable to the claimant as of the date of the most recent certification of job progress received from the general contractor and owner, less any sums already paid the claimant and any contracted retainage.

which he would be entitled to a lien under WASH. REV. CODE ch. 60.04 (1963);
(2) the name of the general contractor, agent or person ordering the same;
(3) a street address of the real property being improved, or if there is none, a legal description;
(4) a description of the services, material or equipment provided by the claimant;
(5) the name, business address and phone number of the claimant.

The notice must be sent by registered or certified mail, return receipt requested, with copies to the owner and general contractor. Ch. 47, § 2(3), WASH. REV. CODE § 60.04.210(3) (Supp. 1973). The notice must be sent at least 20 but not more than 40 days after payment on the claimant's bill is due. Ch. 47, § 2(2), WASH. REV. CODE § 60.04.210(2) (Supp. 1973). The claimant should carefully follow all the above steps; the Washington court has held that because the mechanics' lien is a remedy not available at common law the statute will be strictly construed. Wells v. Scott, 75 Wn. 2d 922, 454 P.2d 378 (1969). This reasoning should also apply to the stop notice.

A "lender" is "any person or entity regularly providing interim or construction financing." Ch. 47, § 1(1), WASH. REV. CODE § 60.04.200(1) (Supp. 1973).

68. The amount to be withheld by the lender is not necessarily the amount claimed by the PLC in his notice:

[T]he lender shall withhold from the next and subsequent draws such percentage thereof as is equal to that percentage of completion as certified . . . which is attributable to the potential lien claimant as of the date of the certification of job progress for the draw in question less contracted retainage. The percentage of completion attributable to the lien claimant shall be calculated from said certification of job progress, and shall be reduced to reflect any sums paid to or withheld for the potential lien claimant . . .

Ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4) (Supp. 1973). This formula is confusing to many in the construction industry, including the mortgage bankers who must use it. Interview with Frank Soderling, supra note 45. One result of this confusion may be that in order to avoid the risk of their lien being subordinated to the subcontractor's claim by the penalty clause of ch. 47, § 2(6), WASH. REV CODE § 60.04.210(6) (Supp. 1973), construction lenders will simply withhold all of the claim.

Interview with Eric Pucher, supra note 50. See text accompanying notes 78–82 infra for a discussion of problems arising when lenders must withhold substantial sums.

69. "Draws against construction financing shall be made only after certification of job progress by the general contractor and the owner or his agent in such form as may be prescribed by the lender." Ch. 47, § 2(1), WASH. REV. CODE § 60.04.210(1) (Supp. 1973). Although a "certification of job progress" is nothing new to most lenders, who already demand comprehensive certificates of job progress on commercial jobs before each draw, the legislature desired that lenders assume this supervisory responsibility on all types of projects to further insure that subcontractors will be paid and the loan money not diverted elsewhere. Interview with Representative Richard
Sums withheld pursuant to a stop notice may be released by the lender only after written agreement between the stop notice claimant, the owner-borrower and the general contractor, or after a court order, unless the lender has the general contractor or borrower obtain a lien-release bond for the claimant in the amount of the claim. If the lender does not abide by the above procedures, and he continues to make loan advances, his mortgage or deed of trust loses its priority to the mechanics' lien of the PLC in the amount of the funds which should have been withheld in response to the stop notice. If the claimant has served an “unjust, excessive or premature” notice he becomes liable for any resulting damages.

A Washington subcontractor will find the stop notice most useful when he has not received his last contract payment for his work on a project and wants to make the lender aware of this fact and give him the opportunity to satisfy this unpaid bill. The stop notice is especially useful in this situation if the subcontractor expects a foreclosure of the lender's prior mortgage or deed of trust, making the subcontractor's potential mechanics' lien of little value. Even if the lender does not

Smythe, Cosponsor of S.H.B. 264, in Vancouver, Wn., Aug. 30, 1973. The change effected by the Act in this regard will be in loans for residential rather than commercial construction, where small builders had in the past more informal draw procedures. Interview with Eric Pucher, supra note 50.

72. See text accompanying notes 83–88 infra.
73. Section 3 of the Act also affects mortgage and deed of trust priority over subsequent encumbrances. See note 29 and accompanying text supra.
74. Ch. 47, § 2(6), WASH. REV. CODE § 60.04.210(6) (Supp. 1973). The stop notice claimant must satisfy his claim by perfecting a mechanics' lien claim under WASH. REV. CODE §§ 60.04.020, .060, .100 and .110 (1963). The mechanics' lien will have this priority over the lender's mortgage, though the mortgage was recorded before the stop notice claimant began work on the project. Interview with Representative Richard Kelley, supra note 65.
76. It is often the case that the first trust deed holder (ordinarily the construction lender) forecloses his deed of trust when a job “goes sour,” as evidenced by the non-payment of laborers and materialmen. Unless the job claimant has a priority over the lender's trust deed, which is seldom the case, the mechanic's lien right of the claimant is terminated by the foreclosure. [In Washington, pendency of mortgage foreclosure does not prevent mechanics' lien foreclosure on the same property. Nason v. Northwestern Mill & Power Co., 17 Wash. 142, 49 P. 235 (1897)] Under these circumstances, the only remedy that the claimant will ordinarily have, in addition to his direct contract cause of action, is resort to the undisbursed construction fund. The claimant will only be able to reach those funds if he has timely filed a stop notice and even if the mechanic's lien right remains viable, the stop notice will prove an effective tool for negotiating with the owner to obtain payment without full litigation.
Moss, The Stop Notice Remedy In California—Updated, 47 L.A. BAR BULL. 299.
299–300 (1972) (footnotes omitted).
pay him, the subcontractor is better off for having filed the stop notice under Section 2, for the subcontractor's subsequent mechanics' lien will have a priority superior to the lender's mortgage—for the amount due under the stop notice—if the lender disburses any more funds and does not withhold any for the subcontractor. The subcontractor, then, must set up an internal procedure to obtain the information required on a stop notice for each job and to ensure that the notices are sent on time and to all the proper parties.  

Because it affects the loan funds held and disbursed by the lender, the stop notice poses the threat of thwarting the success of the lender's venture in at least two situations: (1) When a subcontractor submits a large claim the validity of the amount of which the general contractor disputes, and the lender withholds a large sum to meet the claim, progress on the project will be inhibited until the dispute is settled and the claimant paid; (2) When some subcontractors are not being paid, a rumor that the developer/general contractor is having difficulty getting his draws because the work is not progressing or passing inspection may subject the lender to a flood of stop notices which could effectively halt the project by tying up remaining loan funds until the claims can be adjudicated. When loan money needed to complete the project is withheld from the general contractor by stop notice everyone concerned is hurt. The legislature should provide a special summary proceeding whereby stop notice claims could be quickly adjudicated, both to speed release of withheld funds and to meet possible due process defects in the present procedure.

77. See note 66 supra for the information required on stop notice claims to the lender. In addition, PLC's must be able to show when their contract (or purchase order) payment was due.

78. "The possibility that one claimant can impede the progress of the entire job is probably the major objection to the stop notice remedy." Comment, California Mechanics' Liens, 51 CALIF. L. REV. 331, 353 (1963). See also Illyin, Stop Notice!—Construction Loan Officers' Nightmare, 16 HASTINGS L.J. (1964) [hereinafter cited as Illyin]. This is the biggest worry of general contractors in Washington. Interview with Dick Ducharme, Director of Public Affairs, Associated General Contractors of America, Inc., in Seattle, Sept. 6, 1973.

79. California provides a special summary proceeding to resolve disputes concerning stop notices filed on public projects. If the general contractor or any subcontractor challenges a stop notice claim (by affidavit) to the public entity, the funds withheld will be released unless a counter-affidavit is filed by the stop notice claimant. In that event, either the claimant or the contractor may file in court for a declaration of the respective rights of the parties, and the court must grant a hearing within fifteen days. The court may order the funds released or continued withheld. CALIF. CIV. CODE §§ 3197-3205 (West Supp. 1973).

With the present stop notice provisions, the lender, if he wants to avoid a loss and see the project completed, must have a plan to protect himself against stop notices. He must employ preloan contract precautions, carefully supervise the project to insure subcontractors

held that statutes authorizing the prejudgment impounding of property under less than extraordinary circumstances violate due process unless there has first been notice to the debtor and an opportunity for a hearing. If due process applies to the stop notice remedy, the new Washington Act appears to violate due process. Neither adequate notice nor opportunity for a hearing is provided by the Act; the stop notice claimant merely files a claim with the lender, and the lender is then required either to withhold enough loan funds from subsequent advances to meet the claim, as determined by the formula of ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4) (Supp. 1973), or obtain a lien release bond in the amount of the claim. Id. If the lender makes subsequent advances on the construction loan without first satisfying the stop notice, his mortgage loses its first lien priority to the subsequent mechanics' lien of the PLC. Ch. 47, § 2(6), WASH. REV. CODE § 60.04.210(6) (Supp. 1973). The due process requirements of Snidach and Fuentes for prejudgment impounding of property have been thus characterized: “Absent a valid waiver and except in extraordinary situations, due process requires notice and an opportunity to be heard before any person can be deprived of any significant property interest by state action.” Leen, Galbraith & Gant, Due Process and Deeds of Trust—Strange Bedfellows?, 48 WASH. L. REV. 763, 767 (1973) (emphasis omitted).

Can the Washington stop notice remedy meet each of these due process requirements? First, does the borrower or lender have a “significant property interest” in the funds withheld by stop notice? The answer would appear to be yes, for both parties have contractual rights with respect to these loan funds. Second, does the stop notice effect a “deprivation” of these property interests? It has been argued that a construction loan fund is held in trust for the benefit of those contributing to the improvement, including the stop notice claimant, and hence no “deprivation” occurs. Moss, The Stop Notice Remedy in California—Updated, 47 L.A. BAR BULL. 299, 301-02 (1972). The Washington court seems to accept the trust theory in Columbia Wood Products, 81 Wn. 2d at 900, 506 P.2d at 29-30. Query whether the requisite “deprivation” is present in the stop notice. Third, does the stop notice remedy involve state action? This question resembles the state action question posed by “self-help” under repossessions under UNIFORM COMMERCIAL CODE § 9-503. See Adams v. Southern California First National Bank, 42 U.S.L.W. 2230 (9th Cir. Oct. 30, 1973). It may be significant that the stop notice remedy is purely statutory and not merely a codification of a remedy at common law. 57 C.J.S. Mechanics' Liens § 114 (1948). In this situation, then, it is unclear whether there exists sufficient state action to make the stop notice subject to due process. Fourth, is the withholding of loan funds by stop notice an “extraordinary situation”? Because the stop notice claimant has, in addition, both a personal action against the property owner and the traditional mechanics' lien on the property itself, the stop notice would not seem to qualify under the narrow Fuentes “extraordinary situation” test. Fuentes, 407 U.S. at 91-92. Except for the possible nonexistence of a “deprivation” of property interests by the stop notice, the Fuentes due process requirements seem to apply to the new remedy.

Does the new act comply? As mentioned above, neither adequate notice nor opportunity for a hearing is provided by the Act. The hearing requirement would be satisfied by the adoption of a summary proceeding for stop notice claims similar to the one in California for public works stop notices, supra note 79, so long as the hearing occurs before the stop notice takes effect. As to the notice requirement, California's requirement on private works of a preliminary notice to the owner, lender and general contractor served twenty days before the stop notice may be a solution. It is not clear whether mere notice and the opportunity to go to court to restrain entry of the stop notice order satisfies the “opportunity to be heard requirement” of the due process cases.

It should be remembered that due process rights can be contractually waived. Overmyer v. Frick, 405 U.S. 174 (1972). Such a waiver must be “voluntarily.
are paid and develop procedures to deal with the inevitable stop notices which will be received. Also, lenders should consider exercising intelligently, and knowingly made." Id. at 187. Hence attorneys who represent PLC's and who are uncertain about the constitutionality of Washington's new Act would be well-advised to draft contracts which explicitly waive the due process rights of the borrower or the lender with regard to the stop notice. Absent valid waiver, to satisfy due process deficiencies under the new Act attorneys for PLC's could initiate show cause proceedings ordering opposing parties to appear and show cause either why loan funds should not be withheld to satisfy the stop notice, or why the PLC's mechanics' lien should not be given priority to the lender's mortgage. Such a procedure might be constitutional under the rationale of Rogoski v. Hammond, 9 Wn. App. 500, 513 P.2d 285 (1973) (show cause proceeding under WASH. REV. CODE § 2.28.150 (1963) provides sufficient opportunity to be heard to satisfy due process requirements in a prejudgment attachment situation). If a judicial hearing is required to meet due process objections, it would be preferable to amend the new stop notice statute to establish a special summary procedure tailored to meet the particular needs of the situation which the stop notice provision was designed to remedy. 81. Lenders and their title insurers have always, and still must, supervise the project and insure that loan funds are not diverted elsewhere for the sake of the construction loan's security—the improvement itself. Waivers from subcontractors and indemnities from builders are some protection against mechanics' liens. This procedure need not change. Like subcontractors, however, lenders also must develop new procedures to deal with stop notices which will be received by the lender no matter how carefully he supervises the disbursement of funds. No system of fund disbursement is infallible. The writer's suggested stop notice guidelines for the lender are the following:

(1) If all loan funds have been disbursed after certifications of job progress for each draw, as required by ch. 47, § 2(1), WASH. REV. CODE § 60.04.210(1) (Supp. 1973), then the stop notice is ineffective when received. (2) If a payment bond has been provided equal to at least 50% of the loan, the lender may disregard the stop notice claim if it's from a PLC covered by the bond. Ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4) (Supp. 1973). And if a lien release bond is provided for a particular stop notice claim, no money need be withheld for that claim. (3) The lender should consult the requirements for proper stop notice form in ch. 47, § 2(2), WASH. REV. CODE § 60.04.210(2) (Supp. 1973), listed at note 66 supra. Whether less than strict adherence to these requirements will defeat the stop notice claim is unknown at present, although the Washington court in Wells v. Scott, supra note 66, held that the mechanics' lien remedy will be strictly construed. (4) The lender should retain the envelope in which the stop notice is received because a stop notice mailed more than 40 days after a contract or purchase order payment is due cannot compel withholding for that payment. Ch. 47, § 2(2), WASH. REV. CODE § 60.04.210(2) (Supp. 1973). (5) Is the stop notice claim one for labor and materials on the proper project? The lender need not withhold any part of the claim relating to another, separately funded construction project. If the mistake of the claimant is deliberate, ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4) (Supp. 1973), provides damages for the lender and others. (6) If the notice is valid the lender need withhold only enough funds to satisfy the claim, using the formula of ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4)(Supp. 1973), discussed at note 68 supra. The remainder of the loan fund may be disbursed as originally planned. (Title companies now advise lenders to withhold 100% of the claim and not use the unmanageable formula. Interview with Frank Soderling, supra note 45.) (7) The lender ought to provide in the building loan agreement that the contractor or borrower must provide the lien release bonds described in ch. 47, § 2(4), WASH.
more control over loan disbursements than the progress payment system allows, perhaps by replacing it with a "voucher system" whereby the lender pays the subcontractor directly upon presentation of a voucher.82

Payment bonds83 will exempt the lender from having to withhold loan funds in two situations. If there is a payment bond of at least fifty percent of the construction loan, the lender is not required to acknowledge any stop notice claims which are covered under the bond.84 If the lender can obtain from the borrower or general contractor a

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82. This "voucher system" is popular in California. Dent & Goulden, More on Mechanics' Liens, Stop Notices and the Like, 54 CALIF. L. REV. 179, 199-200 n.118 (1966); Illyin, supra note 78. at 193-94. The California Court of Appeals has made similar suggestions to lenders who want to avoid stop notices:

[A] lender rather than making progress payments according to the reports of its appraiser, that is, solely on the value of the construction work completed, can incorporate provisions in the "Building Loan Agreement and Assignment of Account" for the payment of mechanics and materialmen as a prerequisite to progress payments. Receipted bills can be made a condition precedent to payment. or in lieu of receipted bills, unpaid bills to be paid by check made payable jointly to the owner and the mechanic or materialman, or perhaps to be paid directly to the mechanic or materialman upon order of the owner.


83. A "payment" or "labor and material" bond serves to:

[P]rotect a contracting party from claims by third persons by guaranteeing to the obligee that all labor and material bills incurred by the principal will be paid. Should the principal [here, the general contractor] default, the surety would be responsible to the named obligee [here, the borrower] and also to unpaid subcontractors and materialmen who dealt with the principal, as third party beneficiaries, for payment of labor and material bills.


84. Ch. 47, § 2, WASH. REV. CODE § 60.04.210 (Supp. 1973). In spite of the unequivocal language of ch. 47, a subcontractor's problems may not be solved by a payment bond. For example, a normal payment bond will cover only contracts made
Mechanics' Liens

lien release bond for the benefit of the claimant in the amount of a stop notice claim received, the lender need not withhold any funds for that individual claim.\textsuperscript{85} This lien release bond of Section 2(4) has one disadvantage as a solution to the problem of releasing loan funds once withheld; because most stop notice claims have some validity, a surety will require collateral for the bond, perhaps up to one hundred percent of the claim.\textsuperscript{86}

Although payment bonds are usually provided in large construction projects to assure all subcontractors of payment,\textsuperscript{87} there are several situations in which they are usually not provided and in which subcontractors must rely on stop notices and mechanics' liens: (1) Speculative homebuilding, in which the owner-general contractor relationship is normally not present; (2) where the general contractor is not considered a good risk; (3) where the borrower wants to "risk it" rather than make the expenditure for the bond.\textsuperscript{88}

III. CONCLUSION

The Washington Legislature's 1973 additions to R.C.W. ch. 60.04—the new "stop notice" remedy for subcontractors and the revised mortgage priorities—represent some praiseworthy updating and inno-

by the general contractor, and if the owner/borrower himself contracts for work on the project, the subcontractor will have no recourse to the bond but will have to file a stop notice. And if the payment bond covers only "first tier" subcontractors, it would appear that second or third tier subcontractors will also have their remedy in a stop notice rather than the payment bond.

\textsuperscript{85} Ch. 47, § 2(4), WASH. REV. CODE § 60.04.210(4) (Supp. 1973). This is a bond in which the owner, general contractor, lender or subcontractor is the principal and the stop notice claimant is the obligee/beneficiary for all of the stop notice claim, conditioned to pay any judgment the claimant may recover on his stop notice claim.

\textsuperscript{86} Still, the bond has two advantages: (1) The money withheld by the lender can be released, with the bond satisfying the subcontractor; (2) if the subcontractor is simply paid part or all of his claim, instead of a bond being provided, it might be difficult to get any of this payment back from an insolvent subcontractor when the claim is later adjudicated. Interview with Dick Ericson, Area Surety Manager, Safeco Ins. Co., in Seattle, Sept. 11, 1973.

\textsuperscript{87} Ironically, it is on these large projects, which are usually undertaken by the most responsible and best capitalized parties, that the protection of bonding is least needed by the subcontractor. Comment, Mechanics' Liens and Surety Bonds in the Building Trades, 68 YALE L.J. 138, 167 (1958).

\textsuperscript{88} Interview with Dick Ericson, supra note 86. See PRACTICING LAW INSTITUTE, REAL ESTATE CONSTRUCTION 153 (J. McCord ed. 1969): "You may ask why such a small percentage of private construction work is bonded. Frankly, the only answer that comes to mind is the economic one. Apparently, many owners are reluctant to pay the premium, or perhaps feel that they can get a lower contract price from a contractor who is not required to obtain a bond."
vation within the scheme of antiquated and unfair laws under which the construction industry has been forced to operate. The small subcontractor for whom the mechanics' lien is an unsatisfactory remedy and the homeowner who often paid for improvements a second time solely to remove a mechanics' lien from his property were the intended beneficiaries of the stop notice. Now the subcontractor will often be able to satisfy his unpaid bills directly out of construction loan funds held by the lender for the project, thereby also decreasing the chance that a mechanics' lien will be perfected on the owner's property.

In spite of ch. 47's commendable initiation of the stop notice remedy in Washington, what the legislature sought with the stop notice—a smooth and efficient way for all-important construction monies to be distributed during construction—has yet to be achieved. The formula by which the lender decides how much to withhold in response to a stop notice claim is unnecessarily confusing, and unless the lender is prepared to withhold the full amount the stop notice asks, there seems to be no assurance of a quick resolution of the subcontractor's claim. In addition, the paperwork burden on the subcontractor who wants to make use of the stop notice is unnecessarily heavy. He must keep a mechanics' lien available to himself under R.C.W. ch. 60.04, as well as giving proper stop notice claims under ch. 47.

Although the stop notice means new paperwork and additional supervisory responsibilities for the construction lender, the Act mollifies lenders with favorable new mortgage priorities. They are relieved from the uncertainties and unfairness of Columbia Wood Products; the Act gives all future advances under a mortgage or deed of trust priority over intervening encumbrances on the construction project, even if the advances are voluntary advances.

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