

NEW CASE UPDATE

California Court of Appeal Determines What Constitutes a Good Faith Belief When Serving a Preliminary 20-Day Notice on a "Reputed" Construction Lender

Force Framing, Inc. v. Chinatrust Bank (U.S.A.)
187 Cal.App.4th 1368 (2010)

HOLDING

In a stop notice claimant who has relied upon seemingly correct lender information provided by an owner and/or general contractor is not required to provide proof of checking the county records (i.e., building permit and recorded deed of trust) in order to prove that when it served the preliminary 20-day notice on the wrong lender it held a good faith belief that the "reputed" construction lender was the actual construction lender.

WHY THIS CASE IS IMPORTANT

The decision by the Fourth District Court of Appeal is important to anyone involved in the construction industry. Given the current economic climate in California and the resulting increase in litigation over non-payment, this decision affords greater protection to stop notice and mechanic's lien claimants, while significantly reducing the protections of owners and construction lenders. This decision strays from the strict adherence and harsh penalties associated with a claimant's failure to absolutely comply with all of the necessary prerequisites to perfecting a stop notice and/or mechanic's lien claim. While subcontractors, materialmen and vendors applaud the decision, owners and construction lenders lament the ruling.

FACTS

This case arose out of the construction of a condominium project in Riverside, California. Force Framing, Inc. ("Force") contracted with the owner to provide framing labor, material, equipment and services at the

project. When Force began work at the project, the owner provided Force with a Preliminary Information sheet that identified the general contractor's name, the jobsite address and the lender's contact information. The Preliminary Information sheet identified the construction lender as East West Bank; however, Chinatrust Bank was actually the construction lender.

Consequently, Force served East West Bank with its preliminary 20-day notice based upon the information contained in the Preliminary Information sheet. Subsequently, Force claimed that it was owed \$1,398,882 and served Chinatrust Bank with a stop notice, requesting that Chinatrust Bank hold sufficient funds back from the owner to satisfy the amounts owed to Force. Force then filed a complaint in Riverside Superior Court against Chinatrust Bank, alleging that to the extent Chinatrust disbursed funds to the owner after Force served its stop notice and that now since the remaining funds were inadequate to pay Force, Chinatrust was liable to Force for the amounts owed.

Thereafter, Chinatrust Bank moved for summary judgment against Force arguing that since Force did not properly serve the preliminary 20-day notice on the actual lender, Chinatrust Bank had no obligation to withhold funds from the owner. Chinatrust Bank further asserted that since it had recorded a deed of trust against the property, Force was on constructive notice that Chinatrust Bank was the construction lender and not East West Bank. Force, in turn, asserted that it did comply with the statutory stop notice requirements because it served the "reputed" lender, that it was reasonable for Force to rely on the owner's representation in

the Preliminary Information sheet that East West Bank was the construction lender, and that it had no affirmative obligation to search the county records for Chinatrust Bank's deed of trust.

The trial court granted Chinatrust Bank's motion for summary judgment holding that a subcontractor who seeks a stop notice has a duty to investigate who is the actual construction lender. In other words, the trial court required Force to show that it searched the county records or somehow researched who the actual construction lender was in order to prove that it reasonably, and in good faith, accidentally served the wrong construction lender. Since Force did not inspect the county records or perform any other research to determine the actual construction lender, the trial court concluded that Force could not be excused from serving the preliminary 20-day notice on the wrong lender. Force, along with the Roofing Contractors Association of California, Southern California Contractors Association, and the Engineering Contractors Association, appealed the decision. The Court of Appeal reversed the ruling by the trial court.

DISCUSSION

In this case, the Court of Appeal was presented with the question of what a stop notice is required to show in order to determine that it reasonably and in good faith belief believed the "reputed" lender to be the actual lender. The focus of the decision dealt with the interpretation of California Civil Code § 3097, which sets forth the necessary contents of the preliminary 20-day notice and the service requirements. Specifically, Section 3097 states, in pertinent part, as follows:

"Preliminary 20-day notice (private work)' means a written notice from a claimant that is given prior to the recording of a mechanic's lien, prior to filing of a stop notice, and prior to asserting a claim against a payment bond, and is required to be given under the following circumstances:

(a) Except one under direct contract with the owner. . . every person who furnishes labor, service, equipment, or material for which a lien or payment bond otherwise can be claimed under this title, shall, as a necessary prerequisite to the validity of any claim of lien, payment bond, and of a notice of withhold, cause to be

given to the owner or reputed owner, to the original contractor, or reputed contractor, *and to the construction lender, if any, or to the reputed lender, if any*, a written preliminary notice as prescribed by this section."

In interpreting Section 3097 and determining what the stop notice must prove to show that it had a good faith belief it was serving the actual lender with the preliminary 20-day notice when in fact it served the wrong lender, the Court of Appeal looked to three prior decisions dealing with this issue. Those cases are: (1) *Brown v. Appellate Department* (1983) 147 Cal.App.3d 891; (2) *Romak Iron Works v. Prudential Ins. Co.* (1980) 104 Cal.App.3d 767; and (3) *Kodiak Industries, Inc. v. Ellis* (1986) 185 Cal.App.3d 75. In *Brown* and *Kodiak*, the Third and Fourth District Court of Appeals, held that the determination of whether a claimant held a reasonable and good faith belief that the reputed lender was the actual lender depends on whether "a reasonable person, given the claimant's information, [would] have been led to believe in good faith that the reputed lender was the actual lender"? As such, the *Brown* court held that a stop notice claimant was not required to check the county records and that a good faith belief could be proven by evidence that the claimant relied on information supplied by the general contractor. Similarly, the *Kodiak* court held that the stop notice claimant was not required to check the county records and could rely on the information supplied by the general contractor or owner if the information was "cloaked with sufficient indicia of reliability" to distinguish this information from a mere guess or some ill-founded conjecture.

In contrast, the First District Court of Appeal in *Romak Iron Works* held that the test of whether the claimant had a reasonable and good faith belief is whether the claimant could prove that it examined the county records to ascertain the identity of the lender. In *Romak Iron Works*, the subcontractor served a preliminary 20-day notice on the owner of the project but did not serve the preliminary 20-day notice on the lender and the preliminary 20-day notice identified the construction lender as "Not Known." The subcontract asserted that it was never told there was a construction lender and did no investigation on its own to determine if there was in fact a construction lender, such as reviewing the county re-

cords. As a result, the trial court granted the construction lender's motion for summary judgment, holding that since the construction deed of trust was recorded on title in the county records, the subcontractor was on notice that there was in fact a construction lender. Therefore, the trial court dismissed the stop notice claim against the lender.

On appeal, Force asserted that the *Brown* and *Kodiak* decisions set forth the proper standard and Chinatrust Bank asserted that the court should adopt the rule set forth in *Romak*. The Court of Appeal elected to follow the decisions in *Brown* and *Kodiak* and reversed the trial court's ruling in favor of Chinatrust Bank. The ruling of the Court of Appeal is provided below:

"In other words, if a stop notice claimant has (1) no lender information, or (2) untrustworthy lender information, then the stop notice claimant needs to check county records, e.g., building permits and recorded deeds of trust, in order to prove that he held a good faith belief that the reputed lender was the actual lender. However, a stop notice claimant, who has relied on seemingly correct lender information from the owner and/or general contractor, is not required to provide proof of checking the county records in order to raise a triable issue of material fact as to whether he held a good faith belief that the reputed lender was the actual lender. In sum, we are not persuaded by Chinatrust's argument."

Consequently, the Court of Appeal has further opened the door for owners and construction lenders to be surprised and held liable for monies owed to contractors of whom they have no notice. This decision further provides contractors with additional grounds to deviate from the strict requirements of the statutory preliminary 20-day notice and will no doubt generate further litigation over this issue. As a result, there remains a diversity of opinion between the California Courts of Appeal over what constitutes a good faith belief by a claimant serving a preliminary 20-day notice on a reputed lender. This disparity will not be resolved unless and until the California Supreme Court weighs in on the issue.

Notably, while not directly before the Court of Appeal, it indicated that its analysis pertaining to a

"reputed lender" equally applies to a "reputed owner". Thus, the Court of Appeal stated that the same test set forth above would equally apply to a preliminary 20-day notice that was served on the wrong owner to support a mechanic's lien or stop notice claim, thereby further extending the reach of its opinion.

Based on the above, a prudent contractor should always take the necessary steps to review the county records and perform and document its due diligence in determining who the owner and lender are prior to serving a preliminary 20-day notice. In the event the owner and/or lender identified in the preliminary 20-day notice turns out to be inaccurate, the contractor needs to be able to show a court that it had a reasonable and good faith belief it was serving the actual owner and/or lender. In turn, the prudent owner and construction lender should supply to all parties information accurately identifying the actual owner and lender to ensure receipt of all preliminary 20-day notices to avoid a surprise claim and should also post a sign on the job site conspicuously identifying the proper name and address of the owner and/or lender. Additionally, documentation of the utilization of the sign should be performed through photographs and other means in order to challenge any improper claims by contractors.



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