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No. 65929-4-I

IN THE COURT OF APPEALS, DIVISION I,
OF THE STATE OF WASHINGTON

PACIFIC CONTINENTAL BANK, an Oregon corporation,
and
JOHN P. RADER, Receiver
Respondent.

v.

VILLAGE FRAMERS CORP., a Washington corporation,
Appellant,

BRIEF OF RESPONDENT

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1. INTRODUCTION.

This appeal addresses conflicting priority claims to a portion of the sale proceeds resulting from the judicial sale of a partially completed apartment complex located in King County, Washington. Construction of the project had been financed by Pacific Continental Bank (the “Bank”) with the proceeds of a \$10,300,000 construction loan secured by a first lien deed of trust on the apartment complex. The loan went into default before the project was completed and the Bank sought the appointment of John P. Rader as general receiver (the “Receiver”). After being appointed and qualified, the Receiver determined that a sale of the property in its “as is” condition was the best course of action.¹ On May 24, 2010, the court ordered the Receiver to sell the apartment complex for \$6,500,000.² The trial court further ordered that the Receiver must withhold \$400,000 of the net sale proceeds in an escrow pending resolution of the conflicting lien claims between the Bank and the Appellant, Village Framers, Corp. (“VFC”).³ The trial court later granted the Receiver’s motion for summary judgment granting authority to disburse the entire \$400,000 escrow deposit to the Bank.⁴

¹ CP 54.

² CP 61.

³ Id.

⁴ CP 81.

VFC argues that the trial court erred in granting the Receiver's motion for summary judgment. Essentially, VFC claims that following VFC's service on the Bank of a Stop Notice pursuant to RCW 61.04.221, the Bank's action in placing a hold on \$386,000 in undisbursed construction loan proceeds was not sufficient compliance to satisfy the requirements of RCW 61.04.221(5). The Receiver disputes this position and further argues that, regardless of whether or not the Bank properly withheld funds after receipt of the Stop Notice, the Bank's previous loan advances exceeded the total proceeds of sale and those prior advances had priority over VFC's lien claim.

2. STATEMENT OF ISSUES PERTAINING TO APPELLANT'S ASSIGNMENT OF ERROR.

VFC assigns error to the trial court's grant of Receiver's summary judgment motion.⁵ Essentially, this appeal presents two key issues for the court's consideration:

⁵ Appellant, VFC, argues in subsection (b) to its Conclusion to its Brief that this court should "enter an order granting Appellant's motion for partial summary judgment as to the priority of the lien claim over the Bank's deed of trust ..." However, VFC withdrew its motion for summary judgment prior to argument and issues in that motion are not properly before this court for review. (CP 79.) Furthermore, the Receiver had expressly reserved the right to contest the factual allegations of VFC if the Receiver's summary judgment motion was denied. (CP 70, footnote 2.)

First, does a lender retain its first lien priority on those advances which pre-date the lender's receipt of the Stop Notice?

The Receiver maintains that the answer is yes, and if so, then there is no matter in controversy for this court. At the time the Bank received VFC's Stop Notice, the Bank had already advanced \$8,060,358.90 and the sale generated gross proceeds of only \$6,500,000. Compliance or non-compliance with the Stop Notice statute is simply not relevant in view of the limited sale proceeds.

Second, if the court answers the first issue in the negative, then was the Bank's action in reserving \$386,000 from available loan proceeds sufficient compliance with the Stop Notice statute?

The Receiver maintains that it was sufficient. The statute does not prohibit the lender from disbursing *other loan funds* not subject to the Stop Notice in the lender's effort to further the possibility that construction will be completed for the benefit of all concerned.⁶

3. STATEMENT OF THE CASE.

In October 2007, the Bank made a \$10,300,000 construction loan to Soundview 90 LLC, a Washington limited liability company ("Soundview") in order to finance the purchase and construction of the Soundview Apartments (the "Project").⁷ The loan was secured by a

⁶ Although progress on construction continued for a few months after receipt of the Stop Notice, ultimately, the project failed and the Receiver was appointed and the project sold.

⁷ CP 71, Hogan Decl. ¶2.

Construction Deed of Trust which was duly recorded on October 29, 2007.⁸ Shortly after the loan was closed, construction work began on the Project.⁹

VFC claims to have entered into an oral contract with Soundview to provide framing work required for construction of the Project for a fixed price of \$420,372.¹⁰ VFC subcontracted the framing work to Gordon Harding Construction.¹¹ VFC caused work on the Project to begin on June 23, 2008.¹²

Prior to February 2, 2009, Mastro, a member of Soundview,¹³ informed VFC's president and owner, Scott Daiger¹⁴, that Soundview would have difficulty making timely payment for work performed on the Project.¹⁵ Mastro offered to personally guaranty full payment plus 9% interest on the outstanding balance in exchange for VFC's acceptance of delayed payment.¹⁶ VFC accepted the plan.¹⁷

⁸ CP 71, Hogan Decl. ¶2.

⁹ CP 71, Hogan Decl. ¶ 2.

¹⁰ CP 75, Ex A, Daiger Decl. ¶3.

¹¹ *Id.*

¹² CP 75, Ex A, Daiger Decl., Ex B ¶2.

¹³ CP 75, Ex B, Daiger Supp Decl. ¶4.

¹⁴ CP 75, Ex D, Daiger Decl. ¶2.

¹⁵ CP 75, Ex B, Daiger Decl. ¶9.

¹⁶ CP 75, Ex B, Daiger Supp Decl. ¶10.

On February 12, 2009, Soundview made a payment to VFC in the amount of \$73,000.¹⁸ The February 12th payment was the only payment made by Soundview to VFC since VFC caused Gordon Harding Construction to begin work on the Project over seven months earlier in June of 2008.¹⁹ On June 22, 2009, a full year after beginning work on the Project, VFC submitted a payment request to Soundview.²⁰ The invoice requested payment of \$349,865.53, the unpaid balance of the contract as of that date.²¹ Although the invoice lacked any due date, Mr. Daiger

¹⁷ CP 75, Ex B, Daiger Supp Decl. ¶11-12 and Ex G. As proof of the guaranty, Mastro delivered a promissory note to Scott Daiger dated February 4, 2009 in the principal amount of \$1,187,392. (CP 75, Ex B, Daiger Supp Decl. ¶11-12 and Ex G.) The note was from Mastro payable to the order of Scott Daiger and by its terms was payable on demand. (CP 75, Ex B, Daiger Supp Decl., Ex G.) Mr. Daiger claims he understood that the promissory note was suppose to evidence of Mastro's guaranty, although he also claims that he later learned that this was not the form normally used for a personal guaranty. (CP 75, Ex B, Daiger Supp Decl. ¶13.)

¹⁸ CP 75, Ex B, Daiger Supp Decl. ¶15 and Ex D, Daiger Decl. ¶6. At the trial court, the Receiver reserved argument on the factual question of whether the a timely stop notice from VFC would have been required long before the date it was actually issued. VFC had worked for over seven months with absolutely no payment from Soundview, and then only \$73,000 after Soundview indicated timely payments would not be made and offered a personal guaranty from Mastro together with a promissory note. If VFC issued an invoice in connection with the February payment, based on the total contract amount of \$420,372, then 7/12th (seven months of the entire 12 month contract) would be due, or an amount equal to \$245,217. The \$73,000 payment would be insufficient, ant a timely stop notice would be due within 35 days of the date due, or sometime in March 2010 at the latest.

¹⁹ CP 75, Ex B, Daiger Supp Decl. ¶6. At the trial court and on appeal, the Receiver reserves the right to challenge whether VFC submitted the Stop Notice within the times required by the statute. However, for purposes of review of the trail court's grant of summary judgment, all factual claims by VFC are presumed accurate.

²⁰ CP 75, Ex A, Daiger Decl. ¶5.

²¹ CP 75, Ex A, Daiger Decl. ¶5.

claims that payment was due on or before July 22, 2009.²² The invoice was never paid²³ and VFC filed a lien for \$385,465.48 on August 5, 2009.²⁴ VFC then issued to the Bank a Notice to Real Property Lender (“Stop Notice”) in the same amount dated August 13, 2009.²⁵ The Bank received the Stop Notice on or about August 18, 2009.²⁶

Upon receipt of the Stop Notice, the Bank immediately withheld \$386,000 from loan funds available for payment to Soundview.²⁷ As of August 13, 2009, the date the Stop Notice was signed by VFC, the total of all prior loan disbursements on the Project from the Bank to Soundview totaled \$8,060,358.90.²⁸ After receipt of the Stop Notice and after setting aside \$386,000 of available undisbursed loan proceeds in fulfillment of the Stop Notice requirements, the Bank continued to pay other uncontested draw requests from unrestricted loan proceeds until the total of all loan advances equaled \$9,208,226.13.²⁹

²² CP 75, Ex A, Daiger Decl. ¶8.

²³ CP 75, Ex A, Daiger Decl. ¶7.

²⁴ CP 75, Ex A, Daiger Decl. ¶10.

²⁵ CP 75, Ex A, Daiger Decl. ¶15.

²⁶ CP 71, Hogan Decl. ¶5.

²⁷ *Id.*, ¶6.

²⁸ *Id.*, ¶17.

²⁹ *Id.*, ¶16. The total does not include the \$386,000 which the Bank continued to hold as restricted undisbursed funds.

On November 1, 2009, the Bank's loan to Soundview became past-due, and the Bank then declared the entire loan in default. On December 14, 2009, the Bank filed a Complaint in this action for monies due, judicial foreclosure of its Deed of Trust and appointment of a Receiver.³⁰ Following appointment of the Receiver, the trial court ordered the Project sold in its "as is" partially completed state.³¹ The sale generated gross proceeds of \$6,500,000, from which \$400,000 was set aside by order of the trial court pending resolution of the competing claim of VFC.³² After the Receiver filed a motion for summary judgment, the trial court ordered the remaining \$400,000 in proceeds to be paid to the Bank.³³ Because VFC did not supersede enforcement of the trial court's order (and after notice to VFC), the Receiver fully disbursed the \$400,000 to the Bank.

4. ARGUMENT.

a. **The Receiver has an Obligation to Advise the Court as to Lien Priority.**

Under Washington's Receivership Statute, RCW 7.60.220, the Receiver has an obligation to review claims and file motions regarding any objections. This is in accord with common law of receiverships that

³⁰ *Id.*, ¶10.

³¹ CP 61.

³² *Id.*

³³ CP 61.

when the court orders claims presented to the receiver, the receiver must accept or reject the claims. Clark, A Treatise on the Law and Practice of Receivers (3rd ed. 1959) § 650. The Receiver is under a positive duty to resist any improper claims. *Thompson v. Huron Lumber Co.*, 4 Wash. 600, 607-608, 30 Pac. 741 (1892), *aff'd*, 4 Wash. 600, 31 Pac. 25 (1892). In accepting and rejecting claims, the Receiver acts in many respects as a master, advising the court as to the validity of creditor claims; however, it is the court only, and not the Receiver, who has the authority to approve or disapprove claims. *Morrison-Knudsen Co. v. CHG International, Inc.*, 811 F.2d 1209, 1219 (9th Cir. 1987), *cert. denied*, 109 S.Ct. 358, 102 L.Ed.2d 349 (1987). Clark, at § 650. The Receiver takes property subject to the same equities and liens as existed in the hands of the person or corporation out of whose possession it is taken. *Lloyd v. Rutheford*, 62 Wn.2d 59, 60-63, 380 P.2d 867 (1963).

b. The Bank Retains its Priority on Loan Advances Made Prior to Receipt of the Stop Notice.

It is the Receiver's position that VFC's claim is without merit because the sums advanced by the Bank *before* the Bank's receipt of the Stop Notice exceed the total proceeds resulting from the sale of the Project. On August 13, 2009, the date of VFC's Stop Notice, the Bank had already advanced over \$8,060,000 on the Project. These advances

were secured by the Bank's senior lien pursuant to its previously recorded deed of trust. However, the subsequent sale of the Project yielded only \$6,500,000, far less than the amount of the Bank's senior lien. Therefore, arguments over whether the Bank did or did not comply with the Stop Notice statute do not raise a genuine case in controversy for consideration by this court. The Project simply was not worth enough for the issue to become material.

VFC challenges this position by arguing that an intervening lien claimant who files a Stop Notice can, in effect, have its lien claim leap-over the Bank's prior recorded deed of trust into a new super-priority first lien position. Indeed, VFC's assertion means that VFC's lien leaps to a new priority date that not only primes the Bank's recorded deed of trust, but also pre-dates the date VFC first began doing any work on the Project. This argument not only lacks support under the Stop Notice statute, it is also contrary to the well established lien and mortgage priority rules for construction lenders making future advances.

(i) VFC's Stop Notice Claim Does Not Prime Bank's Deed of Trust Under RCW 60.04.221.

Although RCW 60.04.900 states that the lien statutes are to be liberally construed to provide security for all parties intended to be

protected by their provisions,³⁴ case law has firmly established that mechanics' and materialmen's liens are creatures of statute, in derogation of common law, and therefore must be strictly construed to determine whether a lien attaches. *Lumberman's of Washington, Inc. v. Barnhardt*, 89 Wn. App. 283, 286, 949 P.2d 382 (1997). In order to interpret the mechanics' and materialmen's lien statutes, the court must first look to the plain language of the statute. *Haselwood v. Bremerton Ice Arena*, 166 Wn. 2d 489, 498, 210 P.2d 308 (2009). If the plain language is subject to only one interpretation, the inquiry ends because the plain language does not require construction. *Id.* Absent ambiguity or a specific statutory definition, the court should give the words in the statute their common and ordinary meaning. *Id.* Only where the statute is susceptible to more than one *reasonable* interpretation, will a court resort to statutory construction, legislative history and relevant case law for assistance in discerning the legislative intent. *Id.*

RCW 60.04.221(7) describes the remedy to a potential lien claimant³⁵ if a lender fails to abide by the provisions of the Stop Notice statute:

³⁴ RCW 60.04.900 provides: "RCW 19.27.095, 60.04.230, and 60.04.011 through 60.04.226 and 60.04.261 are to be liberally construed to provide security for all parties intended to be protected by their provisions."

³⁵ In addition to the statutory remedy, the court in *Town Concrete Pipe of Washington v. Redford*, 14 Wn. App. 493, 717 P.2d 1384 (1986), held that the lien claimant may

In the event a lender fails to abide by the provisions of subsections (4) and (5) of this section, then the mortgage, deed of trust, or other encumbrance securing the lender shall be subordinated to the lien of the potential lien claimant **to the extent of the interim or construction financing wrongfully disbursed, but in no event more than the amount stated in the notice** plus costs as fixed by the court, including reasonable attorneys' fees.

RCW 60.04.221(7) (*Emphasis added.*)

The statute on its face provides that non-compliance with the Stop Notice statute shall cause limited subordination of the lender's mortgage or deed of trust. First the subordination does not apply to all advances made by the lender, but only to those advances which constitute "interim or construction financing." Second, subordination is applicable only to the extent that such financing has been "wrongfully disbursed." And third, the statute limits the subordination by another factor, the "amount stated in the notice, plus costs fixed by the court." Contrary to the argument of VFC, these three factors clearly limit the degree to which the lender's deed of trust will be subordinated.

The statute defines "interim or construction financing" in RCW 60.04.011(6) as financing that ***does not include*** advances for things such as funds to acquire the real property, funds to pay interest, taxes, insurance

establish a right to recover under the equitable remedy of unjust enrichment. However, unjust enrichment is not available to VFC in this case because the Project was uncompleted at the time of judicial sale and it sold for less than the total amount advanced by the Bank to pay for labor and materials.

or prior encumbrances, funds to pay loan fees, title expenses, legal fees, recording or appraisal fees, and funds to acquire personal property for which a lien claimant may not claim a lien under RCW Chapter 60.04.³⁶ In substance, this portion of RCW 60.04.221(7) provides that even if a lender fails to comply with the Stop Notice statute, the non-compliance will only result in subordination of a limited class of future advances made by such lender. Advances for those items which are excluded from the definition of “interim or construction financing” are not subject to subordination. This directly contradicts VFC’s central argument that RCW 60.04.221(7) does not permit “partial subordination” of the lender’s “single” deed of trust, or that the court would need to “rewrite the statute” by inserting the words “that portion of” into the statute.³⁷ Indeed, contrary to VFC’s argument, the statute expressly contemplates a narrowly defined range of advances that will be subordinated in the event of lender non-compliance. By definition, certain types of the lender’s future advances are outside the scope of “interim or construction financing” and therefore not subject to subordination.

³⁶ For example, funds disbursed after receipt of a Stop Notice to pay for appliances which were simply delivered to the project and did not become fixtures are not subject to the stop notice statute. See *Emerald City Electric & Lighting, Inc. v. Jensen Electric, Inc.*, 68 Wn App. 734, 738-740, 846 P.2d 559 (1993) interpreting RCW 60.04.200 which was in effect prior to repeal and replacement with RCW 60.04.221 in 1991.

³⁷ See Appellant’s Opening Brief, p.20.

Next the statute further limits the subordination to the extent the financing was “wrongfully disbursed.” Because the statute does not define the words “to the extent” or “wrongfully disbursed,” the common and ordinary meanings should be considered.³⁸ Webster’s Dictionary³⁹ defines the word “extent” as meaning “the range (as of inclusiveness or application) over which something extends” and Black’s Law Dictionary defines “wrongful act” as “Any act which in the ordinary course will infringe upon the rights of another to his damage, unless it is done in the exercise of an equal or superior right.”⁴⁰ Here the only range of disbursements by the lender over which it could possibly have acted “wrongfully” would be those additional disbursements made by the lender *beginning after its receipt of the Stop Notice* and then, *only if done so without regard to the requirements of the statute.*⁴¹ Those disbursements made prior to receipt of the Stop Notice were not made wrongfully by the Bank because they were made pursuant to the exercise of the Bank’s superior right, namely the right to disburse funds to the borrower,

³⁸ *Haselwood v. Bremerton Ice Arena, supra* at 498.

³⁹ Webster’s Third New International Dictionary (1981).

⁴⁰ H. Black, Black’s Law Dictionary(4th ed. 1968).

⁴¹ Whether the Bank made further disbursements without regard to compliance with the Stop Notice statute will be addressed in Section 4.c of this brief.

Soundview, on a secured basis pursuant to the terms of its construction loan deed of trust and without prior receipt of a Stop Notice.

VFC tries to confuse the issue by claiming the language of RCW 60.04.221(7) only sets a dollar limit on the new “first-priority” VFC lien. In effect, VFC argues that the Bank forsakes its entire prior secured lien position to VFC’s alleged new super priority lien. However, VFC ignores the clear direction in the statute that the remedy of subordination applies only to the degree the future advances were wrongfully disbursed. The lender’s prior secured position as to earlier advances is not lost. The Bank had made those earlier advances on the strength of its previously recorded and perfected deed of trust on the Project. The Bank had a vested right to rely upon that priority. Strict construction of the statute, as required by the *Lumberman’s* and *Haslewood* cases, requires that the court conclude that the Stop Notice can only affect the priority of *future advances made after receipt of the Stop Notice*. The statute should not be interpreted to reach a result that causes the lender to lose its prior vested security interest. VFC offers no statutory language, case law or policy argument that supports such a punitive remedy.⁴² Moreover, VFC offers no explanation of why

⁴² If this court were to hold in favor of VFC’s interpretation of the statute, no future construction lender would take the risk to continue funding a partially completed project after receipt of a Stop Notice. Not only would the lender be risking loss of recovery of the possible future advance, but it would be relegating its existing perfected lien to a second lien status. This would give a potential lien claimant the power to bring all

VFC should be given a lien priority above the Bank's, when, at the time the Bank's deed of trust was recorded, VFC had not even begun any work on the Project.⁴³

In addition to the language of the statute, VFC's interpretation is at odds with the well developed body of law in Washington and elsewhere concerning the lien priority of lenders making future advances under prior recorded mortgages or deeds of trust. In the 18 Washington Practice Manual §17.16, Professors William B. Stoebuck and John W. Weaver explain the relationship between optional and obligatory advances and the Stop Notice statute, RCW 60.04.221:

A "future-advances" mortgage is one that contains a clause stating that it is security, not only for a present obligation, but for all or a certain class of obligations the mortgagor may incur in the future. Modernly such mortgages are generally associated with the development of land. They are generally construction-loan mortgages, in which the developer-mortgagor agrees that the mortgage will secure a loan to be paid out in installments, called "progress payments" or "draws," as construction progresses. . . .

construction activity on a project to a complete stop, a power far more significant than a typical lien claimant pursuing a lien foreclosure matter.

⁴³ Simply because VFC can conceive of an alternative interpretation of the statute does not make the statute ambiguous. Even if this court should find the statutory language is susceptible to two interpretations, the statute is not ambiguous merely because different interpretations are conceivable. "A statute is ambiguous if 'susceptible to two or more reasonable interpretations,' but 'a statute is not ambiguous merely because different interpretations are conceivable.'" *Haselwood v. Bremerton Ice Arena, supra* at 498 (quoting with approval from *State v. Hahn*, 83 Wn.2d 825, 831, 924 P.2d 392 (1996)).

To begin with, there is no doubt that future-advances clauses are, and long have been, valid and enforceable in Washington and elsewhere. Between mortgagor and mortgagee, a properly drafted future-advances clause makes the mortgage security for certain designated future advances, if so limited, or for future advances on an open-ended basis if so specified. The rub comes between the holder of a future-advances mortgage and third parties with competing lien or mortgage claims on the same land. **Suppose a construction lender who holds a recorded future advances mortgage makes six progress payments, then a valid mechanic's lien is filed by an unpaid supplier or laborer on the job, and then after that the lender makes three more progress payments. There is little doubt that the six progress payments take priority,** but what about the three that followed the "intervening lien," as it is called? Early Washington decisions indicated that the mortgage lender took priority as to all nine progress payments; after all, the lien claimant had notice from the recorded mortgage that future advances would be made.

A problem for the holder of a future-advances mortgage for its draftsman [*sic*] appeared with *Elmendorf-Anthony Co. v. Dunn* in 1941. Following the lead of a majority of other states, Washington adopted the rule that future advances take priority over intervening liens only if the advances are "obligatory," not if they are "optional" with the lender. In the example above, the last three progress payments would take priority over the mechanic's lien only if they were "obligatory." *Elmendorf-Anthony* did not itself impose a very serious limitation upon the holder of a future-advances mortgage. However, the

celebrated 1973 decision in *National Bank of Washington v. Equity Investors*, familiarly known as the *Columbia Wood Products Case*, created a serious problem for construction lenders and for the drafters of their mortgages. The bank's construction mortgage contained protective clauses, similar to those standard in commercial construction mortgages, that allowed the bank to withhold progress payments for a number of reasons. Not only were there requirements that progress payments had to go into construction and that there had to be architects' certificates of progress, but there was also general language that the bank should make advances only at such times and in such amounts as "Lender shall determine" and that a payment could be withheld if "in the judgment of the lender" the work had not been done well. All these protective clauses together, held the court, made every progress payment "optional": every progress payment would lose priority to all prior liens. For the drafter of a construction loan mortgage, the difficult, if not impossible, task was how to draft a future-advances clause that did not make all advances "optional" and still gave the lender sufficient protection against diversion or wastage of funds advanced.

Had the legislature not intervened after the *Columbia Wood Products Case* came down, construction lenders and the draftsmen of their mortgages would have had a difficult time, keeping sufficient control over progress payments and still not making them "optional." In 1973 the legislature adopted RCWA 60.04.220, which, with minor changes, was re-enacted in 1991 as RCWA 60.04.226. It provides that a recorded mortgage or deed of trust is prior to all subsequently recorded liens, mortgages, deeds of trust, and other encumbrances "to the extent of all

sums secured by the mortgage or deed of trust regardless of when the same are disbursed or whether the disbursements are obligatory." The statutory trade-off is the so-called "stop notice" created by RCWA 60.04.221. Subject to some exceptions, an unpaid potential lien claimant is empowered to give a lender who provides "construction financing" a notice of his claim, whereupon the lender is required to hold back from progress payments enough to cover the claim.

18 W. Stoebuck & J. Weaver, *Washington Practice Manual* §17.16, at 299-301 (2d ed. 2004) (Footnotes and citations omitted, emphasis added).

The lengthy quote from the Washington Practice Manual establishes two critical points. First, *it has long been the rule in Washington that advances made prior to an intervening lien, regardless of whether they were obligatory or optional, take priority over the intervening lien.* Application of that rule to the facts in this case means that the \$8,060,358.90 advanced by the Bank prior to its receipt of the Stop Notice takes priority over the intervening lien claim of VFC. Since the \$6,500,000 in gross sale proceeds were insufficient to satisfy that prior lien amount, there is no excess value to which VFC's lien claim can attach.

Second, prior to the addition of the Stop Notice statute, the priority of VFC's lien claim over the Bank's would have been determined with reference to whether the Bank's advances were "optional" or "obligatory."

If the Bank was obligated by the terms of its loan with Soundview to make the advances, all of the Bank's advances would take priority over VFC's lien claim. However, if the advances were deemed to be "optional," then the advances that predated the Bank's notice of VFC's lien would continue to have priority *and only those advances subsequent to receipt of notice of VFC's claim would be subordinate.*

RCW 60.04.226 has simplified this inquiry by confirming that, except in limited circumstances, all sums secured by the lender's deed of trust are presumed obligatory.⁴⁴ However, this presumption does not apply in the case of violations of RCW 60.04.221. In that case, a lender who elects to "wrongfully disburse" funds after receipt of a Stop Notice receives the same type of subordination of those future advances, as was the case in Washington under the old "obligatory vs. optional" advance rule. The lender making an optional advance does not lose its earlier secured position, but subsequent advances are subordinate to the intervening lien. This is exactly the structure provided by the legislature under the disputed language found in RCW 60.04.221(7).

⁴⁴ RCW 60.04.226 provides in relevant part: "Except as otherwise provided in RCW . . . 60.04.221, any mortgage or deed of trust shall be prior to all liens, mortgages, deeds of trust, and other encumbrances which have not been recorded prior to the recording of the mortgage or deed of trust to the extent of all sums secured by the mortgage or deed of trust *regardless of when the same are disbursed or whether the disbursements are obligatory.*"

c. Did the Bank properly withhold amounts claimed to be due under the Stop Notice?

The leading case in Washington interpreting the Stop Notice statute is *Town Concrete Pipe of Washington v. Redford*, 14 Wn. App. 493, 717 P.2d 1384 (1986).⁴⁵ The court in that case observed that “The stop notice provision, RCW 60.04.210, was devised to provide additional security to those who furnish labor or materials in the erection or improvement of buildings.”⁴⁶ In effect, the Stop Notice gives rise to a right which some commentators have described as an “equitable garnishment.”

‘ . . . 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 . . . ‘

Note, *Mechanics’ Liens: The “Stop Notice” Comes to Washington*, 49 Wash. L. Rev. 685, 695 n. 61. (Emphasis added.)

⁴⁵ Although the court was applying the predecessor to the current Stop Notice statute, the re-enactment only made minor changes to timing and calculation of the amount to be withheld. Under the old statute the amount to be withheld called for complex calculations concerning of the percentage of the lien claimant’s future funding relative to all unfunded amounts. The current statute replaces that calculation with a simple directive to withhold the amount stated in the notice.

⁴⁶ *Town Concrete Pipe of Washington v. Redford*, *supra* at 496.

VFC, however, views the statute very differently. VFC argues in its brief that the purpose of the statute is not to provide a form of additional security, but instead it is intended to act as a device to compel the borrower to seek an early resolution of the payment dispute by withholding critically needed future funding.

“Withholding the construction draw *forces the borrower to actively seek resolution of the payment dispute* or, failing that, to bond around it in order to restore the lender’s ability to release the claimed amount being withheld from its draws.”

Appellant’s Opening Brief at 15.

“This fictional alternative [establishing a reserve against undisbursed loan proceeds] would eliminate the only benefit – and therefore, the purpose – of the statute, namely, *forcing the borrower to pay the lien claim*, post a lien-release bond (which under the statute, would enable the lender to restore its funding of the lien amount) or run the risk of defaulting on its payment obligations or other subcontractors and suppliers resulting in a shutdown of the project.”

CP 76, Appellant’s Motion and Memorandum of Village Framers Corp in Support of its Cross-Motion for Summary Judgment and in Opposition to Receiver’s Motion for Summary Judgment at page 15. (Emphasis added.)

These contrasting views of the same statute are at the heart of the dispute between the Receiver and VFC over whether the Bank properly withheld funds under the Stop Notice statute.

(i) **Stop Notice Statute is not a device to extort early payment from the borrower.**

Upon receipt of the Stop Notice, the Bank immediately reserved \$386,000 against the remaining undisbursed portion of the \$10,300,000 construction loan. Once this amount was set aside, the Bank had fulfilled its obligation under RCW 60.04.221(5) to “withhold from the next and subsequent draws the amount claimed to be due as stated in the notice.”⁴⁷ Although the funds remained the Bank’s property and under the Bank’s control, the Bank could not advance those funds to the borrower without losing its first lien position as to those restricted funds. The Bank’s establishment of the reserve gave rise to an “equitable garnishment” of the borrower’s loan in the form of an assurance that the loan would not be fully disbursed without first addressing VFC’s Stop Notice claim. Contrary to VFC’s suggestion, nowhere in the statute does it prohibit all further funding following receipt of a Stop Notice. Instead, RCW 60.04.221(5) only restricts disbursement of the “amount claimed due as stated in the notice.” Other funds are not restricted. To hold otherwise

⁴⁷ At the time of receiving the Stop Notice, the Bank had disbursed \$8,060,358.90 of the \$10,300,000, leaving a total of \$2,239,641.10 undisbursed. After setting aside the \$386,000 pursuant to the Stop Notice, the Bank was free to disburse up to \$1,853,641.10 from the remaining loan proceeds without violating the statute. However, if at the time of the Bank’s receipt of the Stop Notice a total of \$10,000,000 of loan proceeds had been previously disbursed, then the Bank’s establishment of the reserve would have prevented the Bank from making any further distributions without written agreement of VFC or appropriate court order. RCW 60.04.221(6).

would mean that the legislature intended to cause financial distress for the borrower by short-changing the borrower's draw requests by the Stop Notice amount until the borrower was forced to either capitulate or lose the entire project to financial collapse. No conceivable policy objective could be furthered by this form of brinksmanship. If the legislature had so intended, it would have simply stated in the statute that upon receipt of a Stop Notice, the lender is to stop all funding of the loan until the claim is paid, bonded or further order of the court. The statute does not say that and the legislature did not intend such a result.⁴⁸

VFC cites no authority for its interpretation of the statute, except reference to the liberal construction described under RCW 60.04.900. However, that statute provides that it should be liberally construed to provide security for *all parties* intended to be protected, including the Bank. VFC claims that only VFC is intended to be protected by RCW 60.04.221. Nothing in the statute supports such a claim, and, as noted by the court in *Town Concrete v. Redford, supra* at 497, the lien statutes, being in derogation of the common law, must be strictly construed.

⁴⁸ VFC is more concerned with the lack of immediate pressure on the borrower than the lender's establishment of a reserve. Eventually, the reserved funds will be needed by the borrower and the lien claimant's claim would need to be addressed. However, VFC wants to cause the project to be stopped completely rather than continue to progress while the merits of the claim can be addressed. No conceivable policy argument supports premature termination of funding of a project mid-construction solely on the basis of receipt of a one page Stop Notice.

Last, the Legislature's intent to provide an additional protection for a potential lien claimant is not violated by strict interpretation of the statute. As a general rule, it may be undesirable for a lender to foreclose before a project is finished. The reason is "[m]ore often than not, the market value of a partially constructed building will be substantially less than the total cost of the labor and material which has already been incorporated into its construction.

Town Concrete v. Redford, *supra* at 497-498 (citations omitted).

d. **Receiver's Attorney Fees.**

RCW 60.04.181(3) provides as follows:

The court may allow the prevailing party in the action, whether plaintiff or defendant, as part of the costs of the action, the moneys paid for recording the claim of lien, costs of title report, bond costs, and attorneys' fees and necessary expenses incurred by the attorney in the superior court, court of appeals, supreme court, or arbitration, as the court or arbitrator deems reasonable. Such costs shall have the priority of the class of lien to which they are related, as established by subsection (1) of this section.

In a similar case involving the conflicting priority claims of a secured lender and the issuer of a Stop Notice, the court in *Emerald City Electric & Lighting, Inc. v. Jensen Electric, Inc.*, 68 Wn App. 734, 741, 846 P.2d 559 (1993) held that under the terms of former RCW 60.04.130⁴⁹ the prevailing party in an action to establish lien priority is entitled to an award of attorney fees and costs, whatever the basis for that party's interest in the property may be. In that case the lender, as the prevailing

⁴⁹ Now codified as RCW 60.04.181(3).

party, was entitled to an award of attorney fees and costs in the trial court below and, in an amount to be determined by a commissioner pursuant to RAP 18.1(f), on appeal.

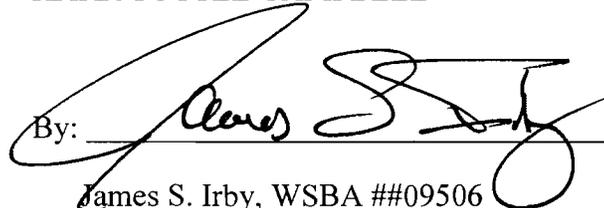
In the case at bar, the Receiver is entitled to an award of attorney fees both on appeal, and, with regard to the summary judgment motion, as determined by the trial court below. Because the amount of the Bank's pre-Stop Notice lien exceeded the value of the Project, the award of attorney's fees should be entered as a personal judgment against VFC pursuant to RCW 60.04.181(2).

5. Conclusion.

This court should affirm the trial court's grant of summary judgment on the basis that: (1) the Bank's prior perfected security interest in the Project at the time of VFC's issuance of the Stop Notice exceeded the value of the Project, and (2) the Bank was in compliance with RCW 60.04.221(5) by establishing a reserve of undisbursed loan funds in the amount set forth in the Stop Notice. This court should also award the Receiver its reasonable attorney's fees pursuant to RCW 60.04.181.

Respectfully submitted this 31st day of January, 2011.

KARR TUTTLE CAMPBELL

By: 

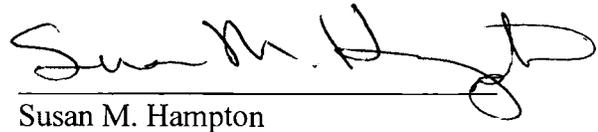
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CERTIFICATE OF SERVICE

I certify that on the 31st day of January, 2011, I served a copy of
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