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## Construction Lender Loses Priority over Lien Claimant

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A recent decision out of the Washington State Court of Appeals may affect how lenders administer construction loans in the future. Specifically, it may affect what lenders do (or should do) when they receive a "stop notice" from one of the vendors on a construction project.

### The Loan

The case is *Pacific Continental Bank v. Soundview 90, LLC*.<sup>1</sup> The loan at issue was a \$10.3 million construction loan to build an apartment complex. The loan was structured as a line of credit, and secured by a deed of trust.

### The Stop Notice

The project ran into problems, and one of the subcontractors filed a mechanic's lien for \$386,000. The subcontractor also issued a stop notice to the lender.

A stop notice is a tool available to contractors and other vendors who are not paid on construction projects financed by a lender.

Subject to certain requirements, the vendor can issue a Notice to Real Property Lender (commonly referred to as a "stop notice"). The notice informs the lender that a lien claim may be filed against the project, and instructs the lender to withhold from any future draws an amount sufficient to cover the lien. If the lender does not withhold the required amount from future draws, the mechanic's lien jumps ahead of the lender's deed of trust in priority.

### What the Lender Did

In *Pacific Continental Bank*, the lender established a reserve after it received the subcontractor's stop notice. It also reduced the amount available on the line of credit by the amount of the lien claim, and issued an alert through its loan accounting system to hold back \$386,000. The lender then continued to make loan advances to the borrower up to the reduced credit limit.

### What the Lender Should Have Done

According to the Court of Appeals, what the lender did in *Pacific Continental Bank* was not right. Once the lender received the stop notice, the lender could have either:

- a. Stopped making advances on the loan altogether; or
- b. If it chose to make future advances, actually withhold part of those advances from the borrower to preserve those funds for the lien claimant.

The lender did neither. It continued to make advances, but it never actually "withheld" any money from those advances for the lien claimant. Instead, the lender continued to make full advances up to the new, reduced credit limit and then stopped. According to the Court of Appeals, this may have protected the lender's interest, in that it preserved the lender's funds, but it did so at the subcontractor's

expense. As a result, the subcontractor's lien jumped ahead in priority over the lender's deed of trust.

### The Practical Consequences

The loss of priority had real-life, practical consequences for the lender. The collateral was eventually sold through a receivership for just \$6.5 million. \$400,000 was set aside

pending resolution of the priority dispute between the lender and subcontractor. Since the subcontractor's lien catapulted ahead of the lender's deed of trust, the entire \$400,000 was eventually awarded to the subcontractor, increasing the lender's already significant loss (the lender advanced a total of \$9.2 million on the line of credit).

This decision seems to have had dire consequences for the lender, but there may be some lessons to be learned from this case as well, depending on your particular situation.

If you have any questions about construction lending or mechanic's liens, please feel free to contact **Magnus Andersson** at (425) 894-4362.

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## About the Author



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Magnus R. Andersson's practice focuses on real estate, construction and banking. He has over 10 years' experience handling property transactions, financing, construction, and leasing matters. Magnus has also resolved numerous disputes on behalf of property owners, contractors, banks and other businesses over the years. Many of Magnus' clients are small to mid-sized companies based in the Puget Sound region of Washington State, but he also works with publicly-traded companies as well as individuals who own real estate.

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<sup>1</sup> 167 Wn. App. 373, 273 P.3d 1009 (2012).