Study H-820 January 31, 2000

Memorandum 2000-9

Mechanic's Liens

Attached to this memorandum is Part 2 of Gordon Hunt's Report, addressing broader proposals for reform of the mechanic's lien law and focusing on legislation introduced in the 1999 legislative session. As Mr. Hunt notes in the Report, most comments made by interested persons at the November 30 meeting related to the currently pending proposals. He also presents the proposals under consideration by the Contractors State License Board (CSLB). His overall conclusion is that the mechanic's lien law is satisfactory, although some clarifications would be appropriate. Mr. Hunt is not in favor of major substantive revision of the statute, and conditionally favors mandatory bonding or the CSLB proposals only as less-objectionable alternatives to the lien recovery fund proposed in AB 742 (facilitated by the constitutional amendment in ACA 5).

In view of Mr. Hunt's opposition to Assemblyman Mike Honda's ACA 5 and AB 742, we are also attaching as exhibits to this memorandum, the bill summary (Exhibit p. 1) and the response (Memo Exhibit pp. 3-14) prepared by Keith Honda in answer to Mr. Hunt's opposition February 3, 1999, letter on behalf of the Building Industry Credit Association. Also attached are some comments from Sam Abdulaziz about the discussion at the November meeting and giving his overview of the different interests at play in the mechanic's lien arena. (See Exhibit pp. 15-19.)

At the February meeting, we will discuss the issues presented in the materials in general terms. Particularly in light of the new Commission membership, this meeting will be an opportunity for interested persons to familiarize the Commission and staff with their views on the policy issues in this area, and what they hope the Commission's role will be (or won't be).

Status of Study

The staff is still collecting and studying relevant materials as time permits, but we have not yet come to any meaningful conclusions. We will continue reviewing materials we have received and we will be looking at approaches in

other states. Our student researchers at the Institute for Legislative Practice have not yet completed their survey of the relevant literature.

As noted above, Mr. Hunt generally concludes that the existing statute is working fairly well, but he suggests a number of technical and minor substantive revisions, as outlined in Part 1 of his study (attached to Memorandum 99-85, presented at the November 30, 1999, meeting). Mr. Hunt also views favorably many of the proposals before the Contractors State Licensing Board (CSLB), as discussed in Part 2 of his Report (see attached Report at 10-11). (We will provide an update on the status of the CSLB projects in a supplement.)

Mr. Abdulaziz concurs in the view that the existing statute should not be changed wholesale, arguing that it would be "foolish to change something that has worked for over 100 years without a study to determine if a problem exists, and if so, the scope of the problems." (Exhibit p. 17.) He, too, suggests looking to the CSLB research and proposals.

Empirical Studies

Those who argue in favor of the existing scheme, while conceding the need for a few adjustments, suggest that there is insufficient evidence of problems under existing law. Reports of abuse are typically dismissed as exceptional or mere "anecdotes." This can be an effective argument in this age of scientific polls and empirical data analysis. However, it can be a barrier to useful law reform if no major revisions can be considered unless a thorough scientific study first determines that there is a significant problem that can be solved by legislation.

The specific empirical issue arising under Assemblyman Honda's bills — the significance of the double payment problem — is difficult for us to assess. Assemblyman Mike Honda's office identified 61 cases occurring over a three-year period, pulling information from a variety of sources. But there is no comprehensive study. The opponents of Mr. Honda's bills have not, to our knowledge, stated what would be a sufficient number of cases to surpass the "anecdote" level.

The Commission is not equipped to conduct statewide data gathering. We have done so on occasion, such as by using questionnaires directed to lawyers practicing in a particular field (e.g., the study concerning probate attorney's fees and the Family Code reorganization), or by gathering information where the target group is small (e.g., corporate trustee fee schedules). In the mechanic's lien area, however, we don't have any better ideas than Assemblyman Honda's office

on how to assess the problem of double payment. We do not believe we can report back to the Assembly Judiciary Committee that no major reforms can be considered or recommended because we have neither the budget nor the expertise to conduct a scientific survey of homeowners and other stakeholders. We would be happy to hear any proposals for conducting the relevant studies, but until then, we will continue our customary practice of relying on the relevant literature, communications from stakeholders and other interested persons, reason, and common sense.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

Assembly
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EDUCATION
PUBLIC EMPLOYEES, RETIREMENT AND SOCIAL SECURITY
REVENUE AND TAXATION

MIKE HONDA
ASSEMBLYMEMBER, TWENTY-THIRD DISTRICT

ACA 5 (Honda) Mechanic's Liens

Summary of the Proposed Constitutional Amendment: ACA 5, as introduced.
ACA 5 creates an exception to California's mechanic's lien laws, where the homeowner has paid-in-full the amount owed to the general contractor for the labor bestowed and material furnished upon the property that would form the basis for the claim of lien. ACA 5 applies only where the subject of the lien is a single-family, owner-occupied dwelling that qualifies as the primary residence of the owner and the homeowner has performed his or her contractual obligations.

ACA 5 protects property rights
Under California's Mechanic's Lien laws, subcontractors, material suppliers, and laborers who have not been paid by the general contractor can leverage payment directly from the homeowner and risk the loss of their homes. ACA protects homeowners by providing a defense to lien claims, when the homeowner has paid-in-full.

ACA 5 protects innocent homeowners
ACA 5 distinguishes between homeowners who are free from wrongdoing and those who are not. Under current law, innocent homeowners can be forced to pay twice or risk the loss of their homes. ACA 5 restores common sense and fairness by ending the practice of subjecting homeowners, who have already paid-in-full, to double jeopardy.

ACA 5 restores the requirement that claims be based on contracts
Under common law, a contractor or material supplier cannot bring an action against a homeowner unless there is a direct contractual relationship creating privity. Mechanic's lien laws, create an exception to the common law requirements of privity, holding homeowners liable to subcontractors and material suppliers even though there is no contractual relationship. ACA 5 requires that homeowners be afforded an opportunity to negotiate a contract.

ACA 5 removes barriers to a free, competitive market
Current mechanic's lien laws interfere with the free market, restricting competition and forcing homeowners to pay for a subcontractor's bad business decisions. A subcontractor (or material supplier) who recklessly disregards valid information regarding the payment history of a general contractor is nonetheless assured payment by the homeowner. The competitive advantage that should accrue to the diligent subcontractor is wiped-out by the subsidies required by the mechanic's lien laws.

ACA 5 allocates risk based on the ability to recover losses
A subcontractor or material supplier, negotiates contracts with regularity and is clearly more sophisticated, understanding more about construction contracts and how best to avoid losses. When a subcontractor submits a bid on a job, the bid includes a premium for overhead and profit. Homeowners make no "profit" and have no access to any mechanism to recoup or "build-in" the loss of double payment.

ACA 5 does NOT impact the rights of lien holders to collect from homeowners who have not paid for services or materials provided. Nor does ACA 5 impact the rights of subcontractors and materially suppliers to recover from the general contractor.

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MEMORANDUM

ASSEMBLY CONSTITUTIONAL AMENDMENT 5

AUTHOR'S RESPONSE

TO

BUILDING INDUSTRY CREDIT ASSOCIATION

Prepared by: Keith M. Honda, Chief of Staff
Office of Assemblymember Michael Honda
February 17, 1999

ASSEMBLY CONSTITUTION AMENDMENT 5
AUTHOR'S RESPONSE TO
BUILDING INDUSTRY CREDIT UNION

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ASSEMBLY CONSTITUTION AMENDMENT 5
AUTHOR'S RESPONSE TO
BUILDING INDUSTRY CREDIT UNION

I. INTRODUCTION

This memorandum has been prepared in response to a letter to Assemblymember Michael Honda, dated February 03, 1999, from the law firm of Hunt, Ortman, Blasco, Palffy & Rossell, Inc. Mr. Gordon Hunt, the senior partner of the firm, authored this letter at the request of his client, the Building Industry Credit Association.

II. THE MECHANIC'S LIEN REMEDY IS AN INEFFECTIVE SUBSTITUTE FOR PRIVITY OF CONTRACT

Every transaction in our daily lives involves some level of risk. In our legal system, contracts serve as a risk management device. Each party to a home improvement transaction incurs some risk. Each party makes an effort to minimize their risk by negotiating a contract. While there may be a number of contracts between prime (or general) contractors, subcontractors, material suppliers, and laborers, the homeowner only enters into a single contract. That contract is between the prime contractor and the homeowner.

When the prime contractor fails to honor contracts with a subcontractor or material supplier, who should bear the risk of this loss? Under California's current mechanic's lien laws, the homeowner assumes the risk associated with a prime contractor's failure to honor his or her contracts with subcontractors and material suppliers.

Mechanic's lien laws create obligations and allocate risk, in the absence of a contract. Is it fair to require homeowner to accept risk, in the absence of an opportunity to manage that risk? The answer to this question is "no," if one takes into account the concept of privity. In the common law, parties do not have claims, unless there is an agreement or contract negotiated between them.

> Under the common law concept of privity, if a subcontractor or supplier feels that there has been a breach of an agreement that subcontractor or supplier may only bring an action against the party with which there is privity – the general contractor or subcontractor engaging the services of the particular subcontractor or supplier. There is no common law ability of the unpaid subcontractor or supplier to bring an action directly against the owners unless there is the direct contractual relationship creating privity. (*Credit Manual of Commercial Laws,* National Association of Credit Management (1995), at page 10-2, emphasis added.)

Hence, though ancient in origin, mechanic's lien laws are an exception to the common law requirement of privity created by a direct contractual relationship.

> A person with a direct contract with the [home]owner can sue the owner directly. Further, that person may be able to attach any of the owner's property (including the property that has been improved) with Mechanic's Lien rights. However, those people that are not in direct contract with the owner (subcontractor, material suppliers, laborers, etc.) cannot secure their rights through the remedy of attachment on any of the [home]owner's property. Except for Mechanic's Lien and Stop Notices actions their

only rights are against the person or entity that contracted with them. (*California Construction Law*, Sam Abdulaziz, Los Angeles: BNI Publications, Inc. (1998), at pages 145-6.)

As discussed in Section II below, statutory noticing requirements, such as the 20 Day Preliminary Notice, are grossly inferior substitutes for a negotiated contract. Service of this notice imputes knowledge and understanding of mechanic's lien laws without any "meeting of the minds," or agreement between the lien holder and the homeowner.

It is patently unfair to jeopardize a homeowner's property rights without first executing a contract between the homeowner and the lien holder. The homeowner's property rights, which are also constitutionally protected, demand greater consideration than that which is granted by the service of the 20 Day Preliminary Notice.

III. EXISTING LAWS ARE INADEQUATE TO PROTECT HOMEOWNERS AGAINST NON-PAYMENT BY PRIME CONTRACTORS: DEFECTS IN THE 20 DAY PRELIMINARY NOTICE

The BICA letter states that existing protections are adequate to "protect" homeowners from the double payment. In support of this claim, the BICA letter cites the "massive" number of statutes enacted in California regulating home improvement transactions. The "massive" nature of these statutes is in reality a testament to the failure of the mechanic's lien laws to adequately provide a substitute for privity. The BICA letter states at page 11:

> [T]he most important protections for the homeowner are set forth in the Mechanic's Lien law itself...It is by virtue of the vehicle of the Preliminary Notice that the owner has knowledge of the potential lien and stop notice claimants and can take steps to see to it that they are paid during the progress of the job.

A closer look at the language of the 20 Day Preliminary Notice reveals the harsh shortcomings of this potential, but questionable, wellspring of protection. The 20 Day Preliminary Notice begins with the following language:

> If bills are not paid in full for the labor, services, equipment, or materials furnished or to be furnished or to be furnished...(Civil Code Section 3097.)

This language raises a number of questions: (1) What is the significance of the word "if"; (2) Whose "bills" does the notice refer to; and (3) Who is obligated to pay the "bills." A fair reading of this language provides the following set of answers. The answer to question 1: "if" establishes a condition that must occur before any action is required; that condition is non-payment. The answer to question 2: the sentence is silent and unclear regarding "whose bills" are involved. The answer to question 3: again the sentence is silent and ambiguous regarding "who is not paying" in-full.

Therefore, it appears that a homeowner reading this notice could reasonably assume the following: (1) Since the notice was served to him or her that the notice refers to his or her bills; (2) That "if" means he or she needs to take action only if he or she does not pay; (3) That since he or she intends to pay all of his or her bills in-full that the remainder of the sentence does not apply to him or her and can be disregarded. The homeowner could reasonably conclude that the purpose of the notice is to remind the homeowner to

pay all of his or her bills in-full, because payment in-full will provide protection from mechanic's liens and any foreclosure action.

As discussed in the Section I, the 20 day preliminary notice is a grossly inferior substitute for privity of contract. For the notice to serve the purpose described in the BICA letter, it requires an interpretation that is counterintuitive. It requires that the homeowner interpret the word "bills" to mean the bills of the prime contractor. It also requires that the condition of non-payment be interpreted as referring to the non-payment of the prime contractor, an action over which the homeowner has no direct control. It is unreasonable to expect any homeowner to interpret the notice in this manner, specifically because the "prime contractor" is not mentioned in the sentence.

Finally, the 20 Day Preliminary Notice cannot have the intended effect if it is received after final payment is tendered. A significant percent of small home improvement projects (such as roofing, water heater, furnace or air conditioning, and landscaping) are all completed in less than a week. The 20 Day Preliminary Notice in these types of circumstances could be received well after final payment is tendered.

For example, work on a small home improvement project starts on April 1, ends on April 8. Final and full payment is tendered on April 10. The 20 Day Preliminary Notice is delivered to the homeowner as late as April 20, a week after the final payment is made. In this example, Preliminary Notice serves no notice, because it is received after the fact. A homeowner has no knowledge of any potential lien at the time final payment is tendered. The homeowner can take no action to ensure that potential lien claimants have been paid because the homeowner does not know they exist.

IV. EXISTING PROTECTIONS ARE RENDERED USELESS WHERE THE PRIME CONTRACTOR IS UNCOOPERATIVE OR FULL AND FINAL PAYMENT IS MADE BEFORE THE 20 DAY PRELIMINARY NOTICE IS DELIVERED

The effectiveness of some of the "protections" available to the homeowner is time sensitive. If certain timing elements are not present, the protections are rendered useless. Other protections are dependent on the cooperation of the prime contractor. The party from whom the homeowner is seeking protection, the prime contractor, can frustrate the homeowner's ability to qualify for the protection sought.

If the 20 Day Preliminary Notice is delivered after the homeowner tenders full payment, it renders several of the other "protections," (e.g., lien releases and joint checks) useless. A homeowner can only call for lien releases if he or she is served a notice by potential lien claimants before making final payment. The same problem arises with respect to the "joint checks" protection. Joint checks can only be issued if the homeowner has prior knowledge of all the potential lien claimants and is informed of the amounts owed.

A homeowner depends on the prime contractor to deliver lien releases. The unscrupulous prime contractor can withhold lien releases while at the same time continuing to pressure a homeowner for final payment. Even where the homeowner demands lien releases and the prime contractor delivers them, these releases offer limited protection against double payment. "Conditional" lien releases are valid only when the payments from the prime contractor have been cleared by lien holder's bank. If a prime contractor stops payment on the lien holder's check, a conditional lien release offers no protection to the homeowner, because the condition (payment received by the lien holder) has not been satisfied.

To utilize joint checks, a homeowner must be delivered a notice by the prime contractor informing them of the joint checks protection (B&P Code Section 7018.5). More importantly it requires that the prime contractor provide information regarding the names of each potential lien holder and the specific amounts owed to each. Without names and numbers, it is impossible to issue a joint check. Again, it is not difficult for an unscrupulous prime contractor to withhold information that the homeowner seeks.

In order to function as fully intended, a homeowner "protection" must be free and clear of influence or cooperation of the prime contractor. In addition, a protection cannot be dependent on information contained in the 20 Day Preliminary Notice. Neither the lien releases nor the joint check protection meet this criteria.

The existing protections represented by lien releases and joint checks are wholly inadequate, because they fail to address the source of the double payment problem: the inability of subcontractors, material suppliers and other lien holders to enforce the contracts negotiated with the prime contractor.

V. EXISTING STATUTORY PROTECTIONS FOR SUBCONTRACTORS AND MATERIAL SUPPLIERS AGAINST NON-PAYMENT BY PRIME CONTRACTORS ARE INADEQUATE

A review of relevant code sections, confirms that there are a "massive number of statutes" attempting to regulate home improvement transactions. The BICA letter cites a number of statutes in the Civil Code and Business and Professions (B&P) Code that are designed to discipline contractors who do not honor their agreements with homeowners, subcontractors, or material suppliers, or otherwise violate the law. A number of these sections are specifically designed to protect the subcontractors, material suppliers, and laborers.

Subcontractors are protected against non-payment by B&P Code Section 7108.5, which disciplines prime contractors who fail to pay subcontractors within 10 days of receiving payment. Material suppliers are protected by B&P Code Section 7120, which disciplines prime contractors for failing to pay for materials. Laborers are protected from being forced to provide a release if they have not been paid (B&P Code Section 7110.1). The prompt payment statutes cited in the BICA letter provide for penalties if payments due on a home improvement contract are not made in a timely manner. These statutes protect the prime contractor against late payments by homeowners (Civil Code Section 3260) and subcontractors against late payments by prime contractors (B&P Code 7108.5 and Civil Code 3260).

These codes sections may very well provide the incentive to assure compliance of the vast majority of prime contractors. However, if one assumes that so-called "rogue" prime contractors have no regard for the law, it follows that statutory penalties will not succeed in modifying their behavior. For this reason, statutory penalties have failed to provide subcontractors and material suppliers with the means necessary to leverage payment from "rogue" prime contractors.

One can, at this point, reasonably conclude that resolution of the problem, the non-payment of subcontractors (or material suppliers), requires that we look beyond statutory penalties and protections and consider substitute sources from which to pay subcontractors and other lien holders.

VI. UTILIZATION OF A SUBSTITUTE SOURCE OF PAYMENT DELIVERS EQUITABLE PROTECTION TO BOTH THE HOMEOWNER AND THE SUBCONTRACTOR

A homeowner may or may not understand his or her obligations, rights, or duties under the Mechanic's Lien laws. The knowledge of the homeowner, however, is not the factor which determines whether he or she is placed at-risk of double payment. The key factor is whether the prime contractor honors his contracts to subcontractors and material suppliers and pays.

Consider the following hypothetical. In a sample of 10 home improvement transactions, there are 10 uninformed homeowners. They do not understand mechanic's lien laws and the protections provided in the law. In the first 9 of the 10 transactions (#1-9), the homeowners each hire honest prime contractors, who honor their contracts with subcontractors and material suppliers. In the remaining transaction, #10 in this hypothetical, the homeowner hires an unscrupulous prime contractor. Which homeowner is most at-risk of becoming the subject of mechanic's liens?

If the prime contractor honors all agreements and pays subcontractors, the homeowner -- who knows nothing about mechanic's lien laws, but pays in-full -- will not be subjected to a mechanic's lien. This is because subcontractors, material suppliers, and other lien holders that have been paid, have no incentive to file mechanic's liens. The homeowners in hypothetical transactions #1-9 are lien free not because of the homeowner's vast knowledge of mechanic's lien law, but because the prime contractor pays.

The homeowner who almost certainly will find himself or herself subject to a mechanic's lien is the homeowner involved with the unscrupulous prime contractor. The critical factor to focus on is "payment," not the homeowner's knowledge of existing mechanic's lien protections. If the subcontractors, material suppliers, and other lien holders are not paid, they will record mechanic's liens. This is what subjects the homeowner to double payment.

The key to eliminating the risk of homeowner double jeopardy is payment. As long as lien holders get paid, the homeowner's knowledge or understanding of mechanic's lien laws remains irrelevant. Therefore, the most equitable protection for both homeowner and subcontractor lies in identifying or creating an alternative source of payment which is made available to subcontractors, material suppliers, and other lien holders. It goes without saying any alternative source of payment for subcontractors cannot rely in any way on the cooperation of the prime contractor. The following section evaluates contract bonds as a possible (substitute) source of payment.

VII. PAYMENT AND PERFORMANCE BONDS ARE AN INADEQUATE SUBSTITUTE SOURCE OF PAYMENT FOR SUBCONTRACTORS

The BICA letter states very clearly support for bonds as a protection for homeowners. At page 10 the BICA letter states:

> [Business and Professions Code Section 7018.5] specifically advises the owner that they may want to require their contractor to supply a payment or performance bond.

In addition to citing the Bentz case at page 11, the BICA letter continues at page 12-13:

> More needs to be said concerning the payment bond provisions of the Mechanic's Lien law. Under the Mechanic's Lien law, the owner may insulate [his or her] property from Mechanic's Liens and may insulate [his or her] construction loan funds from bonded stop notices (except a bonded stop notice of the original contractor who has not been paid) by obtaining a payment bond. Specifically under Civil Code Section [3235], the owner obtains a payment bond equal to fifty percent (50%) of the contract price from the general contractor and records it in the office of the County recorder. The owner also files the prime contract...As a practical matter where the owner has required [his or her] contractor to put up a payment bond and the owner has paid the contractor in full, no court would impose a lien on that owner's property...Civil Code 3236, likewise, provides that it is appropriate for the owner to protect [himself or herself] against the failure of the exacting such a bond from the contractor.

The application process for a performance or payment bond is very stringent. The construction industry refers to contract and other bonds as "surety bonds" and the companies that issue bonds are "surety companies." The main reason that is so difficult for contractors to qualify for bonding is the nature of surety bonds. The surety business (and bonding) is fundamentally different from insurance:

> Insurance is a two-party risk transfer mechanism whereby one party pays to have another party protect them from certain well-defined risks. In purely theoretical terms, insurance is a pool created by large number of people exposed to a common risk...The contribution to the pool is determined by an actuarial study of the probability of loss...Surety, on the other hand, is a three-party relationship which is more in the nature of a credit transaction. Unlike insurers, sureties do not expect to suffer losses...The other fundamental difference between surety and insurance is that sureties demand reimbursement from their principals [contractor]...in the event of a loss. (*The Basic Bonding Book* (1993), published jointly by the Associated General Contractors of America and the National Association of Surety Bond Producers, at page 1.)

Qualifying for a bond commits the applicant to a process that is very involved, less like an application for insurance and more akin to an application for credit. According to the *Bonding Book* (at pages 5-11), a surety or bonding company will request the following information from a contractor applying for a bond: (1) resumes of the contractor and key people in the contractor's organization; (2) a listing of work successfully completed; (3) trade references; (4) an organizational chart of the contractor's firm; (5) a business continuity plan; and (5) the rationale for choosing the particular project to be bonded. The contractor is also asked to establish that he or she has sufficient financial strength to support a bond and is asked to provide the following: (1) a balance sheet; (2) statement of earnings; (3) statement of changes in owner's equity; (4) a statement of cash flow; and (5) information from the contractor's CPA regarding his or her companies accounting methods.

However attractive payment bonds may be, in theory, they are quite a different in reality. Stephen R. Elias, in his book entitled, *Contractors' and Homeowners' Guide to Mechanic's Liens*, (Berkeley: Nolo Press, 1998) states:

> Although this approach to reducing mechanics' lien risk [exacting a bond from a contractor] may seem like a good idea, most general contractors will not quality for a payment bond equal to 50% of the overall project cost...As a general rule, this owner protection is seldom used except on extremely large projects involving highly bondable

general contractors and price tags that allow the cost of the bond to absorbed into the larger project. (at pages 9/12-13, emphasis added.)

Bonding remains an unsatisfactory homeowner protection simply because it is very unlikely that the unscrupulous prime that fails to pay his or her subs will qualify for a bond. Contractors with the qualifications to satisfy surety companies are those least likely to fail to make payments and break contracts with lien holders. If bonds were mandatory (as suggested at page 13 of the BICA letter), the "rogue" prime contractor who disregards prompt payment and licensing regulations, is unlikely to follow a new law mandating bonding. Like other "protections" discussed in earlier sections, bonding is flawed because it depends on the cooperation and honesty of the prime contractor.

It is important to note, like homeowners, subcontractors, and material suppliers can utilize bonds to protect themselves from prime contractor non-payment. Subcontractors and material suppliers can, in theory, "exact" bonds from contractors and homeowners to assure payment. However attractive this option may be in theory, reality is again very different. Just as prime contractors have knowledge and expertise superior to the homeowner, the prime contractor also possesses a dominant bargaining position over subcontractors and material suppliers. In reality, few if any, subcontractors or material suppliers are in a bargaining position to exact a bond from a prime contractors.

Very much like a bond, the homeowner's property provides a guaranteed source of payment of obligations to subcontractors and material suppliers. However, unlike the surety company, the homeowner does not sign a contract assuming the risk or acknowledging his or her role as surety. Until ACA 5 becomes law, it is the homeowner who unwittingly provides the "de facto" bond and acts as the surety for subcontractors and material suppliers.

VIII. ACA 5 IS NARROWLY CONSTRUCTED TO LIMIT ITS ECONOMIC IMPACT ON THE CONSTRUCTION INDUSTRY

ACA 5 is carefully drafted to protect a narrow class of homeowners: those who are owners of single-family owner occupied homes and have paid the prime contractor in-full. The BICA letter correctly identifies two cases where ACA 5 will have no impact. ACA 5 does not change current law as it applies to the construction of new homes, nor does ACA 5 apply to home improvement contracts where the homeowner has not paid-in-full. ACA 5 in no way impact the rights of lien holders in cases where the homeowner has not paid-in-full.

IX. ACA 5 ALLOCATES RISK BASED ON THE ABILITY TO MANAGE RISK AND ABSORB LOSSES

A subcontractor is frequently a licensed and skilled craftsperson. A subcontractor or material supplier negotiates contracts and manages risk with regularity. It is his or her daily responsibility to assess risk and to negotiate contracts with general contractors. In contrast, a homeowner does not add a room, change a furnace, replace a water heater, or put on a new roof with regularity. These activities take place once every 20 years (a roof), once every 15 years (a furnace), and every 10 years (a water heater).

Businesses are profit-making enterprises. A company's ability to distinguish between bad and good business partnerships is a significant factor in determining whether a company is successful at delivering a product to market on time and at a competitive price. Business partners who are reliable, delivering payments and services promptly, decrease business interruptions, improve productivity, and increase opportunities for profit.

However, in pursuing profit, every business suffers losses. A subcontractor "builds-in" profit and overhead into the bids submitted to the homeowner. This, at least in theory, creates an opportunity to recoup losses (factored into "overhead") from the occasional "bad deal" where the general contractor fails to pay. In contrast, a homeowner does not seek to "profit" from home improvement transactions, but pays the "market rate." Homeowners do not have access to any mechanism to recoup the loss of paying twice.

X. ACA 5 DISTINGUISHES BETWEEN THOSE HOMEOWNERS WHO ARE FREE FROM WRONGDOING AND THOSE WHO HAVE BEEN UNJUSTLY ENRICHED

The purpose of the mechanic's lien laws is to ensure that those who contribute labor and material to a work of improvement receive payment for those improvements -- even if this means that homeowners pay twice. The BICA letter states, "[t]hat to hold otherwise, would allow the owner to obtain the benefits of material and labor without compensation and result in unjust enrichment of the owner at the expense of the lien claimant."

Mechanic's lien laws are fair when the homeowner is unjustly enriched. When the homeowner accepts the work of improvement but refuses to pay, he or she is unjustly enriched. When contractors and material suppliers perform and homeowners refuse to pay, the mechanic's lien remedy is appropriate as an "interim remedy" as described in the Connelly case. The homeowner is in breach of contract and is therefore guilty of wrongdoing.

The above situation is distinguishable from a situation where subcontractors or material suppliers are not paid, but the homeowner has paid the general contractor in-full. A homeowner that pays-in-full pursuant to a valid contract is not unjustly enriched. He or she is merely receiving the benefit of the bargain. In this situation, the homeowner is not in breach of any contract and is free from wrongdoing. The party unjustly enriched is the general contractor, not the homeowner. The general contractor, who absconds with payment owed the subcontractor or material supplier, is in breach of contract.

Current law makes no distinction between the parties who breach contracts and those that are free from wrongdoing. The homeowner who performs his or her contractual obligations cannot be held responsible for the obligations of the unscrupulous general contractor. ACA 5 establishes protection for the innocent homeowner who is free from wrongdoing.

XI. ACA 5 PROVIDES INCENTIVES TO HOMEOWNERS TO SETTLE DISPUTES WITH PRIME CONTRACTORS AND WILL REDUCE THE NUMBER OF FORECLOSURE CASES FILED

The BICA letter states if ACA 5 becomes law, the costs of mechanic's lien foreclosure litigation will rise substantially, because disputes will arise regarding "full payment." At page 4, the BICA letter states:

> There are often many substantial disputes between owners and prime contractors as to whether or not the owner has 'paid in full' the amount owing from the owner to the prime contractor. What this Constitutional Amendment will do is add another substantial issue to each and every mechanic's lien foreclosure action that the parties will have to litigate. In each case, the unpaid subcontractors and material suppliers will have to file their action to foreclosure and engage in discovery to determine whether or not the owner

> has in fact paid the contractor in full. Obviously, the owner will have to spend time and attorney fees with [his or her] attorney to litigate the same issue. Thus, the cost to the owner of mechanic's lien foreclosure litigation [*sic*] will rise substantially as a result of having to litigate this dispute.

ACA 5 will not cause the number of cases litigated to increase. ACA 5 will reduce litigation and related costs to homeowners. In fact, ACA 5 provides an incentive for homeowners to not engage in disputes with prime contractors over amounts owed.

Under ACA 5, if a homeowner establishes that he or she has paid the prime contractor in-full, a foreclosure action by subcontractors or material suppliers will not succeed. It is in a homeowner's interest to provide proof of payment to all lien holders to discourage filing of frivolous foreclosure actions. A homeowner who desires to avoid a foreclosure action is not likely to force a lien holder to utilize discovery in order to obtain this information. In this manner, ACA 5 can both eliminate the need for costly discovery and reduce the number of foreclosure cases filed.

ACA 5 also provides an additional incentive for homeowners to expedite the settlement of disputes with the prime contractor over what the owner owes as "final and full payment." The BICA letter correctly points out that a homeowner who disputes a $2,000 change order will lose the protection ACA 5 provides. Thus, the threat of the loss of ACA 5 protection can provide leverage that can help prime contractors resolve disputes with homeowners. For this reason, ACA 5 is likely to facilitate speedy resolution of disputes regarding "final payment" in favor of the prime contractor.

XII. ACA 5 IS CONSISTENT WITH TAX AND BANKRUPTCY LAWS WHICH ALSO RECOGNIZE THE DISTINCTION BETWEEN OWNER-OCCUPIED HOMES AND OTHER TYPES OF PROPERTY

The BICA letter states that there is "no reason" to distinguish between classes or types of property owners. There are a number of reasons to distinguish a single family owner-occupied homes from other types of property ownership. Owner-occupied homes have special standing in several areas of law. Owner-occupied dwellings benefit from special tax breaks both during ownership (mortgage interest deductions) and upon sale (capital gain tax). Owner-occupied homes also receive special treatment under bankruptcy laws. ACA 5 is consistent with these and other long standing laws that make distinctions between single-family owner-occupied homes and other types of property.

XIII. ACA 5, WHEN INCORPORATED INTO THE CONSTITUTION, WILL RISE TO A CONSTITUTIONAL COMMAND

The BICA letter cites a number of cases that interpret the law relating to mechanic's liens in California. These cases are helpful in understanding how the courts have viewed the provisions relating to California's mechanic's lien laws. The courts in these cases grant great deference to the "constitutional command" of Article XIV, section 3, of the California Constitution. Due to the constitutional nature of California's mechanic's lien laws, they have been "liberally construed" by the courts.

If ACA 5 is incorporated into the California Constitution, it too will rise to the level of a constitutional command. It will be liberally construed by courts to protect the homeowner, while at the same time protecting the rights of subcontractors, laborers, and material suppliers.

XIV. CONCLUSION: ACA 5, COMBINED WITH A WELL-DESIGNED LIEN RECOVERY FUND, PROVIDES THE MOST EQUITABLE PROTECTION FOR BOTH HOMEOWNER AND SUBCONTRACTOR

There are several inescapable conclusions to be drawn from the preceding analysis. First, the laws of California are failing subcontractors and material suppliers, as well as homeowners. The laws of California are failing in efforts to coerce prime contractors into honoring contracts with subcontractors and material suppliers. Second, any focus on homeowner knowledge and notice is misplaced. The pivotal factor in determining whether a lien is perfected is not homeowner knowledge, but the willingness and ability of a prime contractor to honor contracts with subcontractors and material suppliers. Third, any effective homeowner "protection" cannot be dependent on the cooperation or acquiescence of a prime contractor. A "rogue" prime contractor can subvert so-called "protections" dependent on his or her cooperation.

The BICA letter states at page 14, that a legislative solution worth considering is a "lien recovery fund." A lien recovery fund meets the criteria set forth in Section V, by providing an independent source of payment for lien holders that cannot be frustrated by an unscrupulous contractor. Assuming that participants in a home improvement contract assume common risks, a lien recovery creates a pool of money to insure against those common risks. In short a lien recovery fund modeled after Utah's statutes (Title 38, Chapter 11 UCA), can if designed properly, provide the benefit of bonds without the restrictions which prevent prime contractors from qualifying for bonds.

Therefore, the key to resolving the dual problem of subcontractor non-payment and the homeowner double jeopardy is not joint checks, lien releases, or bonds, but a two-part remedy, addressing the distinct problems of homeowner and subcontractor. Fairness commands that homeowners be provided a defense of full-payment against the lien rights of subcontractors, material suppliers and other lien claimants. ACA 5 makes this provision in the law. Fairness also commands that subcontractors, material suppliers (and other lien claimants) be paid. This is best accomplished by providing an independent source of payment for these lien claimants: a lien recovery fund.

ACA 5 combined with a well-designed lien recovery fund, provides the most equitable protection for both homeowner and subcontractor.

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REVISED LETTER

January 3, 2000

Stan Ulrich, Assistand Executive Secretary
CALIFORNIA LAW REVIEW COMMISSION
4000 Middlefield Road Room D-1
Palo Alto, CA 94303-4739

RE: MECHANIC'S LIEN STUDY

Dear Mr. Ulrich:

I was one of the people at your November 30, 1999 meeting covering the referenced matter. As I indicated to you when I spoke, I'm an attorney in a law firm that emphasizes construction law. Although we represent prime contractors and material suppliers, our main group of clients are subcontractors. It is for that reason that we are becoming involved in this study.

I personally lecture to the construction trade on the subject of mechanic's liens, stop notices and bonds as well as contract rights, etc. Most of my seminars are to the trade. However, some of my seminars have been approved for continuing education of the Bar. I have qualified as an expert in these areas before the courts.

I give you the foregoing as background for my point of view and to illustrate that I am a practitioner in this field and not a lobbyist. However, I try to be objective.

In general, the term "mechanic's lien" describes a bundle of rights dealing with the improvement of real property. The bundle of rights includes stop notices and payment bond rights. At this point, it would be too technical to describe how each item works. However, I suspect that your staff and your consultants will bring you completely up to speed on all of them.

Unless otherwise noted, my comments will be referring to the bundle of rights rather than the mechanic's lien rights alone.

Each of the people that spoke before you tended to have differing points of view. Your consultant gave you a very good overview of the lien process and its history. I would not attempt to better that explanation. Although some had argued before you as to your

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consultant's point of view, there's no question but that he has laid out the process for you and gave you an accurate history.

What may not have been sufficiently pointed out, is that mechanic's liens, in addition to providing security for being paid, provide an additional entity to sue that material suppliers and subcontractors would not otherwise be able to sue. That is, in the typical scenario there is no contractual relationship between subcontractors or material suppliers and the owner of the project. Given that, the mechanic's lien allows subcontractors and material suppliers to sue the owner through an action in rem. Further, in a mechanic's lien action, the damages are for the value of the improvement and no deficiency judgment can be had in the lien action.

There are substantial differences between the various parties that you have heard from to date and will hear from in the future. Clearly, prime contractors would prefer to limit the lien rights if kept at all. That is because prime contractors have a direct contract with the owner and can enforce their rights contractually without jumping through the number of hoops that the mechanic's lien process requires them to do.

Title insurance companies do not like the liens because they are an off-record cloud on title. Generally, a mechanic's lien attaches when work first begins on a construction project. However, at that time nothing is recorded. Therefore, the property is subject to being clouded but the cloud is not a matter of public record. This is the very reason that title insurance companies do not like mechanic's liens. However, there are two types of title insurance policies. One that just searches the record and another when the insurer goes out and looks at the property. If one looks at the property, they can usually discern whether any construction is going on that might cause a potential lien to exist that would or may have priority over a potential buyer or lender.

Owners do not like mechanic's liens because they are a cloud on title and may require them to deal with a subcontractor or material supplier even though they may have already paid their prime contractor for the work that was done. Realtors do not like mechanic's liens because they may keep escrows from closing quickly.

However, there is a method for releasing mechanic's liens through the use of a mechanic's lien release bond. This type of bond substitutes the bond as security in lieu of the property. Your consultant advised you that the lien has been held to be constitutional, and is not an unconstitutional "taking."

As I stated during your last meeting, although you have been charged by the Legislature to review the process, one of the things that must be looked at is whether the process needs wholesale changing rather than minor changes that are similar to the ones that have been made over time. It seems foolish to change something that has worked for over 100 years without a study to determine if a problem exists, and if so, the scope of the problems. I suggest that you recommend to the Legislature that it directs and authorizes the Contractors' State License Board to retain a company to study the scope of whether problems exist and the scope. By doing things such as searching public records, interviewing people and any other method that researchers would deem appropriate.

I also urge you to obtain information derived by the Contractors' State License Board dealing with this issue. There are other ways to protect owners, including owners of single-family, owner-occupied, residences. I would urge you to have your staff contact Ellen Gallagher, Staff Attorney, Contractors' State License Board, P.O. Box 26000 Sacramento, CA 95826, to obtain information and suggestions. Some ways to protect owners that come to mind are more descriptive notices, checklists to be given to the owner to be used before making payments, etc. As an aside you have been told that owners of single-family, owner-occupied residences need additional protection because they are not sophisticated in the process. Our experience would indicate that the contractors that are performing this type of work are no more sophisticated in the process than the typical owner.

Quite honestly, it appears to me that the very first thing this Commission should do is determine whether wholesale changes in the process are appropriate. I have heard nothing but anecdotal statements. I don't believe that much needs to be done.

Importantly, I believe that when you consider all of the tentacles **of the construction industry, it is the largest industry in the** State of California. Yet I am not aware of any significant number

of people that have suffered a loss because of the "mechanic's liens" bundle i.e., lost their homes or have paid twice. Indeed the only "large scale" problem occurred in the 1970's when Sunset Pools filed for bankruptcy leaving approximately twenty-five pools unfinished. That was many years ago. Certainly this is not sufficient to merit the proposed upheaval in the constitution and civil code.

On the other hand, the financing of construction projects leaves contractors severely leveraged. Typically, contractors work on a very narrow margin of profit -- something like ten percent. If they are not paid timely, or if their payments are not made at all, one can see that it would take a whole lot of profitable jobs to make up for only one unprofitable job. Without lien rights more contractors could go bankrupt, substantially hurting the economy. It is for that reason that I urge the Commission to not recommend making wholesale changes in the mechanic's lien process unless they are proven truly necessary.

Specific Suggestions

As I stated earlier, we agree with the consultant's analysis almost to the letter. We have three differences and those are detailed herein.

The Consultant's Proposed Changes To Civil Code §§ 3115 & 3116

First, we would allow contractors of all tiers and material suppliers to file a stop notice whenever they were due money and not paid rather that having to wait until they complete their tasks (original contractors may not serve an owner with a stop notice). The reason for that is that the stop notice ties up construction funds. If one were to wait until they were completed with all of their work, then much of the construction funds may have been already distributed. Therefore, there would be very little left to tie up or to assure payment. In order for the stop notice to be effective there needs to be a construction fund.

Proposed Changes To Civil Code § 3262

Secondly, with respect to the Conditional and Unconditional Waiver and Releases upon final payment, we would leave words to the effect that the release does not cover contract claims. The reason for that is that the amount of the mechanic's liens goes to the value of the improvement of real estate. Contract claims could be very different and broader. As an example, a material supplier may be entitled to interest at the rate of one and one-half percent per month pursuant to their contract with their customers (generally a subcontractor). However, they are only entitled to the statutory rate of interest on the mechanic's lien. Similarly, one may be entitled to attorneys fees on a contract action but not entitled to attorneys fees on a mechanic's lien claim. Breach of contract damages could also include lost profits or other consequential damages. That is not true with mechanic's liens.

Lastly, with respect to the two Unconditional Releases, there is a statutory notice. Your consultant carries that same general tenor along. It seems to me that it would be appropriate to put in words to the effect that the Unconditional Release waives any claim even if the releasor accepts a check that later is dishonored by a bank. The reason for including that language is that the general rule in the State of California is that if a check is dishonored it is as if that check was never given. There are no cases on point; however, it seems to me that based on the language of the present notice in the statute, people may be giving up their rights regardless of whether the check they receive is honored or not.

Please keep us as an interested party in this matter.

Respectfully Yours,
ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ

SKA:tmw

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Study H-820

Report to Law Revision Commission Regarding Recommendations for Changes to the Mechanic's Lien Law [Part 2]

Gordon Hunt

February 2000

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739
650-494-1335 FAX: 650-494-1827

Recommendations for Changes to the Mechanic's Lien Law
[Part 2]

Gordon Hunt

CONTENTS

1. Introduction

On November 16, 1999, Part 1 of the Mechanic's Lien Study was presented to the Commission pursuant to Memorandum 99-85. As noted in said Memorandum, pursuant to a request from the Assembly Judicial Committee, the Commission agreed to conduct a comprehensive review of the Mechanic's Lien law on a priority basis. The letter from the Assembly Judicial Committee is attached as an Exhibit to Memorandum 99-85.

Part 1 of this Report was submitted in November of 1999. Part 1 dealt with minor substantive and technical revisions. As noted in Memorandum 99-85, the Commission plans to consider Part 2, which will consider broader issues of reform along with other materials at the Commission's second meeting in February 2000.

As noted in Memorandum 99-85, issues have been presented in recent and pending bills. One bill mentioned in said Memorandum is AB 171 submitted by Margett.

Also before the Assembly Judiciary Committee was ACA 5 and AB 742 by Assemblyman Honda, which together would restrict Mechanic's Liens on single-family owner-occupied buildings and establish a Default Recovery Fund for payment of certain unsatisfied obligations of contractors.

As set forth in Memorandum 99-85, the Commission does not take positions on bills but speaks to the Legislature through its own recommendations and bills. However, the subject has been referred to the Commission by one of the policy committees that regularly sees bills concerning Mechanic's Liens and therefore, it is the judgment of the committee that the subject needs a comprehensive review. As noted in Memorandum 99-85, the Commission will not depart from its practice of not taking positions on pending bills, however, it will be necessary to consider the issues raised in the pending bills and the various alternatives to address any potential problems in the law.

In Part 1 of this Report, the issues raised by AB 171, ACA 5, and AB 742 were not addressed at the request of staff. At the hearing on November 30, 1999, the two primary issues of discussion by parties appearing at the hearing centered

around AB 171, ACA 5, and AB 742. It is the purpose of this Report to address those additional issues.

2. Proposal To Eliminate Lien Rights on Single-Family, Owner-Occupied Residences

ACA 5, together with AB 742, proposes that lien claimants shall not have the right to record a Mechanic's Lien on a work of improvement consisting of an single-family, owner-occupied residence where the owner has "paid the contractor in full."[1] The purpose of the legislation was to protect the private homeowner from having to "pay twice." There was substantial support and substantial opposition to that legislation.[2] The Contractor's State License Board (CSLB) who would be administering the trust fund that would substitute for the Mechanic's Lien where the owner had paid the contractor in full opposes the legislation.[3] The CSLB has, in turn, proposed their Home Improvement Protection Plan for the year 2000.[4]

The arguments in support of the proposed legislation are hereinafter set forth. First of all, it should be noted that the proponents of the legislation evidently feel that there is a need for the legislation. That is, on home improvement contracts involving the owner of a single-family residence which is owner-occupied often pay their contractors in full and still end up with Mechanic's Liens on their property. The first argument of the proponents of the legislation is that the Mechanic's Lien remedy is an ineffective substitute for privity of contract. The proponents contend that the homeowner assumes the risk associated with the prime contractor's failure to honor his or her contracts with subcontractors and material suppliers. They argue that since the owner has a contract with the contractor and has paid the contractor in full, the owner should not have to pay twice when the contractor, in turn, fails to pay its subcontractors or suppliers. The proponents of the legislation also contend that the existing laws are inadequate to protect homeowners against non-payment by original contractors and that there are defects in the Preliminary Notice. The proponents of the legislation contend that the warning contained in the Preliminary Notice (Civ. Code § 3097) is inadequate. They take the position that an owner reading said notice would assume that as long as the owner paid the original contractor, they would be fully protected. They further contend that on very small projects, the 20-Day Notice is received after the owner has paid the contractor in full. They further contend that the statutes which protect homeowners are inadequate. They contend that the sections of the Business and Professions Code imposing obligations on contractors to pay their subcontractors and suppliers are inadequate to protect the homeowner from the "rogue" original

1. For the text of ACA 5, see Exhibit pp. 1-2; for AB 742, see Exhibit pp. 3-5; for the Assembly Judiciary Committee consultant's analysis of ACA 5, see Exhibit pp. 6-17.

2. Support and opposition are listed at Exhibit pp. 15-17.

3. See Exhibit pp. 19-22.

4. See Exhibit pp. 23-62.

contractor who fails to abide by the law and fails to pay the subcontractors and suppliers. They further contend that payment bonds are inadequate to substitute as a source of payment for subcontractors. They contend that most contractors on home improvement contracts would be unable to obtain surety bonds guaranteeing payment to subcontractors and suppliers. They take the position that their legislation is narrowly drafted to protect a narrow class of homeowners, to-wit, owners of single-family owner-occupied homes who have paid their original contractors in full.

In essence, the proponents of this legislation contend that the Mechanic's Lien law, as it currently stands, does not provide adequate protection to the owner of a single-family owner-occupied dwelling where a work of improvement is constructed, they have paid their contractor in full and that contractor, in turn, fails to pay subcontractors and supplier. As a result of the foregoing, they perceive a necessity for the legislation in question.

As noted in Part 1 of this Report to the Commission, the Mechanic's Lien law has long been a part of California law. The first California statute relating to Mechanic's Liens was the Act of April 12, 1850.[5] The basic right to a Mechanic's Lien is guaranteed by the California Constitution of 1879 and has remained unchanged to this date.[6] The California Constitution provides that suppliers of labor, services, equipment and materials have a lien upon real property for which they have bestowed such labor, services, equipment and materials and that the Legislature shall provide for the "speedy and efficient" enforcement of that lien. No other creditor's remedy enjoins such "constitutionally enshrined status."[7]

There does not appear to be any substantial evidence that the problem which the legislation seeks to address is a prevailing problem in the construction industry. No evidence has been submitted that there are a substantial number of "homeowners" who have been the victims of the problem of "double payment." This problem has been asserted before the Legislature in the past, but the Legislature has never seen fit to alter the current protections that exist in the law that protect owners. In fact, there is no evidence that this is a substantial problem. As noted in Part 1 of this Report, the California Supreme Court in the *Connolly* case[8] recognized that the protective policy of the Mechanic's Lien law serves the needs of the construction industry. As pointed out by the California Supreme Court in the *Connolly* case, labor and material suppliers are in a particularly vulnerable position. Their credit risks are not as diffused as those of other creditors. They extend a bigger block of credit and they have more riding on one transaction and they have more people vitally dependent upon eventual payment. They have much more to lose in the event of a default. As a result, there must be some procedure

5. Roystone Co. v. Darling, 171 Cal. 526, 530 (1915).
6. *Id.* at 530-31.
7. Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal. 4th 882, 889 (1997).
8. Connolly Dev., Inc. v. Superior Court, 17 Cal. 3d 803 (1976).

for the interim protection of contractors, subcontractors, laborers, and material suppliers in that situation. Without such protection, the improvements could be completed, the loan funds disbursed and the land sold before the claimant can obtain an adjudication on the merits of his or her claim. As noted by the California Supreme Court, as to the interest of the owner whose property is subject to the Mechanic's Lien, the owner suffers only a minor deprivation by reason of the lien since the owner retains possession and use of the property and furthermore, the owners whose account is subject to a Stop Notice, suffers only the encumbrance of the very funds that he or she has previously allocated for the exclusive purpose of paying construction costs. Without recourse to prevent the owner from disposition of the property, the claimant would be left with only an unsecured and potentially uncollectible claim for compensation for the labor, service, equipment or material that has enhanced the value of the property itself. The Supreme Court in the *Connolly* case also acknowledges that the owner and lender can protect themselves against liens and Stop Notices by securing and recording a payment bond from the general contractor under Civil Code Sections 3161, 3162, and 3235. The Supreme Court noted that before recording the Mechanic's Lien or filing a Stop Notice, the claimant is required to serve a Preliminary Notice upon the owner, contractor and construction lender under Civil Code Section 3097. The Supreme Court noted that upon receipt of such notice from one not entitled to claim a lien, the owner or construction lender could immediately file a suit to enjoin the claimant from asserting his or her lien under Code of Civil Procedure Section 526. Further, the owner could, by the use of a temporary restraining order, if necessary, (under Civil Code Section 527, secure a hearing before the lien was, in fact, imposed. The Supreme Court noted that even after the lien has been recorded or a Stop Notice filed, the owner could seek a mandatory injunction ordering the claimant to release the lien. The Supreme Court noted that the owner need not wait until the claimant sues to enforce the lien by reason of the fact that the imposition of the lien and the owner's denial of its validity compromises a controversy sufficient to permit an immediate suit for declaratory relief under Code of Civil Procedure Section 1060. Such a declaratory relief action would have priority on the calendar of the trial court under Code of Civil Procedure Section 1062(a). By filing a action for injunctive or declaratory relief, the owner or lender could obtain a hearing either before imposition of the lien or within a reasonable period thereafter. The Supreme Court therefore concluded that the recordation of the Mechanic's Lien and the filing of the Stop Notice inflicts upon the owner only a minimal deprivation of property; the laborer or materialmen have an interest in the specific property subject to the lien since their work and materials have enhanced the value of the property; state policy strongly supports the preservation of laws which give the laborer and materialmen security for their claims; in measuring those values, the Supreme Court indicated that it did not deal in cold abstractions in that it took into account the social effect of the liens and the interest of the workers and materialmen that the liens are designed to protect and measured those liens against the loss, if any,

caused to the owner; the Supreme Court concluded that the balance tips in favor of the workers and materialmen and therefore concluded that the safeguards provided by the California law to protect property owners against unjustified liens are sufficient to comply with due process requirements and therefore the Supreme Court upheld the constitutionality of the Mechanic's Lien and Stop Notice laws.

The removal of the Mechanic's Lien remedy on home improvement contracts would adversely impact small subcontractors and material suppliers and their employees. The inability to enforce a Mechanic's Lien could result in bankruptcy of the subcontractor and the loss of wages to the employees who worked on the property. Another economic impact would be that contractors and subcontractors would have a much more difficult time in obtaining credit on single-family owner-occupied dwellings. Without the protection of the lien law, many subcontractors would refuse to bid on or work on those types of projects and contractors and subcontractors would find it difficult to find material suppliers that would extend credit to them on those types of projects. This, in turn, would reduce the number of contractors and subcontractors either able or willing to work on home improvements contracts and would drive up the cost of those projects to the homeowner. As a result, the very person that the proposed legislation seeks to protect would be adversely affected from an economic standpoint. Without the availability of the Mechanic's Lien law, material suppliers would most likely put contractors and subcontractors on a COD basis requiring contractors and subcontractors to pay for the materials either before or contemporaneously with delivery of the materials. The contractors and subcontractors on home improvement contracts typically do not have the financial wherewithal to finance both the labor and material costs up front before receiving payment from the owner. To eliminate the right to a Mechanic's Lien in this limited circumstance would adversely impact the construction industry from an economic standpoint, which is one of the primary industries in the state of California.

There are existing protections in the law that adequately protect owners against the so-called "double payment problem." The owner, at the beginning of the job, is going to receive Preliminary Notices from the subcontractors and material suppliers. The Preliminary Notice itself puts the owner on notice that if those parties are not paid, that Mechanic's Liens may be filed. Specifically, the Preliminary Notice required under Civil Code Section 3097 contains the following notice to owner:

> If bills are not paid in full for the labor, services, equipment, or materials furnished or to be furnished, a mechanic's lien leading to the loss, through court foreclosure proceedings, of all or part of your property being so improved may be placed against the property even though you have paid your contractor in full. You may wish to protect yourself against this consequence by (1) requiring your contractor to furnish a signed release by the person or firm giving you this notice before making payment to your contractor or (2) any other method or device that is appropriate under the circumstances.

(It should be noted that this notice was altered inadvertently by legislation that took effect on January 4, 2000. This error is currently being corrected by legislation.)

The Contractors License Law requires that the contractor furnish to the owner of a home improvement project a notice fully advising the owner of the Mechanic's Lien law. Specifically, Business and Professions Code Section 7018.5 requires a contractor entering into a contract with an owner, specified as a home improvement or swimming pool contract, to serve a notice to the owner.[9] That notice carefully advises the owner as to the primary provisions of the Mechanic's Lien law and specifically advises the owner that they may want to require the contractor to supply a payment or performance bond to fully protect the owner. The Contractors License Law has many other provisions that protect homeowners in that it is a ground for disciplinary action for the contractor to abandon a construction project (Bus. & Prof. Code § 7101); to divert or misapply funds (Section 7108); failure to pay subcontractors within ten days of being paid (Section 7108.5); require an unpaid laborer grant a release (Section 7110.1); material failure to complete the project for the price stated in the contract (Section 7113); material failure to comply with the license law (Section 7115); willful and fraudulent act injuring another (Section 7116); willful failure to prosecute work diligently (Section 7119); willful failure to pay money when due for material or services or false denial of liability to obtain a discount or delay (Section 7120). Contractors and subcontractors have knowledge of these provisions of the Business and Professions Code and operate with knowledge of these provisions, which provide them incentive to promptly construct the project and pay the subcontractors and suppliers.

The courts in California have recognized various ways in which an owner may protect his or her interests. Specifically, in the case of *Bentz Plumbing & Heating v. Favalaro*,[10] the court states:

> We do not mean to denigrate the legitimacy of the owner's interest in knowing whether and how much subcontractors and materialmen with potential lien claims on his property have been paid by the prime contractor. We observe, however, that there are several means of protecting their interests. The property owner may limit his lien liability to the measure of the prime contract price by recordation of the contract where a payment bond has been obtained by the prime contractor in an amount equal to 50 percent of the contract price. (Civ. Code, §§ 3132, 3235, 3236.) The owner may himself, by purchase and recordation of a payment bond in like amount, secure priority over mechanics' liens. (Civ. Code § 3139; Connolly Development, Inc. v. Superior Court, *supra*, 17 Cal.3d at p. 808.) Finally, defendants could have issued joint checks to pay for each subcontractor's work (i.e., checks made out to the prime contractor and the subcontractor or materialman as joint payees). Estoppel may be invoked against a subcontractor which endorses a joint check, on the ground that its inclusion as payee makes it clear that the maker

9. See notice at Exhibit p. 63.

10. Bentz Plumbing & Heating v. Favaloro, 128 Cal. App. 3d 145, 151 (1982).

> of the check intends thereby to discharge his obligation to the subcontractor. (Post Bros. Constr. Co. v. Yoder (1997) 20 Cal.3d 1, 5-6 [141 Cal. Rptr. 28, 569 P.2d 133]; Re-Bar Contractors, Inc. v. City of Los Angeles (1963) 219 Cal. App.2d 134, 136 [32 Cal.Rptr. 607]; see also Cal. Construction Contracts and Disputes (Cont.Ed.Bar 1976) §§ 3.55, pp. 123-126; *id.* (Cont.Ed.Bar Supp. 1981) pp. 15-16; Cal. Mechanics' Liens and Other Remedies (Cont.Ed.Bar 1972) § 6.19, p. 161; id., (Cont.Ed.Bar Supp. 1980) pp. 41-42 [importance of using joint checks due to unsettled interpretation of Civil Code § 3262]; Moss, Application of the Doctrine of Estoppel in Construction Industry Litigation (1974) 49 L.A. Bar Bull. 250, 254 [same].)

[Footnotes omitted.]

At noted above, the California Supreme Court in the *Connolly* case stated that the owner and lender can protect themselves against Stop Notices and Mechanic's Liens by securing and recording a payment bond from the original contractor.

The Mechanic's Lien law itself already has adequate provisions protecting owners. Specifically, under the Mechanic's Lien law, the owner may insulate its property from Mechanic's Liens and may insulate its construction loan funds from bonded Stop Notices by obtaining a payment bond. Specifically, under Civil Code Section 3235, if the owner obtains a payment bond equal to 50% of the contract price, from the contractor, and records it in the office of the County Recorder and files the prime contract, the court must restrict recovery under Mechanic's Lien claims to an amount equal to the amount found due from the owner to the original contractor. Thus, if the owner obtains such a payment bond from the contractor, where the owner has paid the contractor in full, the owner will have no liability under the Mechanic's Lien law. Civil Code Section 3236 provides that it is the intent and purpose of Civil Code Section 3235 to limit the owner's liability to the measure of its contract price with the contractor. Civil Code Section 3236 provides that it is appropriate for the owner to protect itself against the failure of the original contractor to make full payment for all work done and materials furnished by exacting such a bond from the contractor. This, of course, was the Legislature's way of balancing the interests of the owner and the interests of the contractor and the unpaid subcontractors, laborers, and material suppliers. It, in effect, provides that the owner will never have to pay twice if the owner obtains a payment bond from the original contractor. The California Supreme Court long ago analyzed the rights of the owner versus the rights of the contractor, subcontractors, laborers, and material suppliers. Specifically, in the case of *Roystone v. Darling*, the court analyzed the Mechanic's Lien law and the method pursuant to which the Legislature addressed the rights or the owner versus the rights of the lien claimants. Civil Code Sections 3235 and 3236 were the Legislature's way of balancing the interests of the lien claimants versus the interests of the owner. Said sections provide that the owner can protect itself against the failure of the original contractor to make full payment for all work done and materials furnished by exacting a payment bond from the original contractor. This balancing of the interests of the owner (to limit the owner's liability for liens to its contract price so that the owner will not

have to pay twice) against the interests of the claimants to be paid where they have improved the owner's property by the simple expedient of bonding the job for 50% of the contract price was extensively analyzed in the landmark case of *Roystone*. Although a very old case, it is still good law and clearly spells out the reason and effect of the bonding provisions. The Supreme Court noted the following: Prior to the adoption of the Constitution of 1879, the lien was a creature of statutes; numerous decisions of the Supreme Court declared that liens were limited by the contract price between the owner and the contractor and could not, in the aggregate, exceed the contract price; the Constitution of 1879 guaranteed the Mechanic's Lien remedy and directed the Legislature to provide for its speedy and efficient enforcement; the statute of 1880 contained a direct declaration that the lien shall not be affected by the fact that no money is due on the contract; in the case of *Latson v. Nelson*,[11] the court considered the power of the Legislature to disregard the contract of the owner and give liens to laborers and materialmen for an amount in excess of the money due from the owner to the contractor and declared that the Constitution was not intended to impair the right of contract and therefore, provisions of the Code granting third parties' lien rights in disregard of and exceeding the obligations of the owner was an invalid restriction of the liability of contract; the Legislature in 1885, recognizing the decision in *Latson v. Nelson*, sought to regulate the mode of making and executing contracts regulating the timing and amounts of progress and final payments; that law remained in effect until the 1911 revisions of the lien law; the cases had held that if there was a contract, that contract limited the amount of liens; the statutes from 1885 to 1911 did not work well; the Act of 1911 was designed to remove the objections to the former law; the revisions of 1911 allow the owner total freedom of contract with the contractor; the 1911 revisions allow the owner to file the contract and record a payment bond for 50% of the contract price and thereby limit its liability for liens to its contract price with the contractor; the 1911 Act provides that the liens shall be direct liens and shall not, in the case of claimants other than the contractor, be limited by the contract price between the owner and contractor (it should be noted that the foregoing is the same principle applicable to the current lien law); the purpose of the 1911 Act was to reverse the policy of the prior act and to now make liens direct against the owner's property and independent of any account of indebtedness between the owner and contractor; the Legislature made the liens direct liens and not limited by the contract price between the owner and the contractor and the intent of the statute was to limit the owner's liability to the contract price where the owner has filed the contract and recorded the payment bond (it should be noted that is still the law in Civil Code Section 3235); where the bond had not been obtained, the contract price is immaterial to the lien (except as to the contractor); where the bond has been obtained and recorded, the contract price controls and the account of the indebtedness from the owner to the contractor is

11. 2 Cal. Unrep. 199, 11 Pac. Coast L.J. 589 (case not officially reported).

decisive on the amount of the lien; in view of the fact that the Constitution grants lien rights and that the Legislature shall provide for the speedy and efficient enforcement of those lien rights, these bonding provisions of the statute which give the owner a "reasonable and practical" mode to improve his or her property through a contractor at a fixed price without further liability is a legitimate exercise of the Constitutional mandate; the 1911 revisions do not deprive the owner of the right to contract to improve his or her property and at the same time exempt his liability for liens by providing reasonable security for the Constitutional right of lien (that is, the payment bond) is "not an unreasonable burden"; the bond required by the Act of 1911 is provided for the express purpose of enabling the owner to escape liability for his or her building in any sum in excess of the contract price; the concurring opinion of Justice Henshaw stated that it was wholly beyond the power of the Legislature to destroy or even impair the constitutionally guaranteed lien right. The foregoing analysis and statements by the Supreme Court in 1915 are as valid today as they were in 1915. The Legislature has balanced the interests of the owner and the lien claimants. The owner can limit its liability for liens and Stop Notices to its contract price if it files the contract and obtains from the contractor a payment bond for 50% of the contract price and records the same. AB 742 adds the additional administrative scheme which is unnecessary and burdensome to the owner, contractor, and lien claimants. The owner is well protected under the existing provisions of the Mechanic's Lien law.

In addition, the Mechanic's Lien law provides for indemnity to the owner for the defaults of the original contractor in failing to make payment to subcontractors, laborers, and suppliers. Specifically, Civil Code Section 3153 provides that where a claim of lien is recorded for labor, services, equipment, or materials furnished to any contractor, that contractor shall defend any action brought thereon at his own expense and during the pendency of such action, the owner may withhold from the original contractor the amount of money for which the claim of lien is recorded. In the event a judgment is entered in the action against the owner foreclosing the lien, the owner is entitled to deduct from any amount due the original contractor the amount of such judgment. If the amount of the judgment exceeds the amount due from the owner to the original contractor, or if the owner has settled with the original contractor in full, the owner is entitled to recover from the original contractor or the sureties on any payment bond any amount of such judgment costs in excess of the contract price for which the original contractor was originally the party liable. In other words, the owner is indemnified by the Mechanic's Lien law for the default of the original contractor in failing to pay subcontractors, laborers, and suppliers.

In light of all the foregoing, it is clear that there is adequate protection that already exists in the myriad of statutes governing the construction industry in the State of California. The proposed statute is unnecessary and would have a substantial adverse economic impact on the construction industry and small homeowners.

It would also eliminate the lien rights of laborers who had participated in building the home.

There are other ways in which the owner could be protected against the "alleged double payment" problem on single-family owner-occupied works of improvement. There are numerous alternatives that could accomplish the purpose which the proposed statute seeks to accomplish. In addition to the bonding of the project, which the owner can currently do under the Mechanic's Lien law, another alternative would be to make the furnishing of a payment and a performance bond mandatory in the case of a single-family owner-occupied dwelling that is the primary residence of the owner. The Mechanic's Lien law could be amended to set forth appropriate provisions requiring bonding in those limited circumstances. The cost of the bonding, of course, is passed on to the owner and it would increase the cost of the project to the owner, but it would provide the owner with ultimate protection from a defaulting original contractor. It would completely serve to protect the owner from the failure of the original contractor to pay subcontractors, laborers, and suppliers. It would likewise protect the owner from failure to complete by the original contractor. The primary objection to any such statute would be claims by contractors that they would be unable to obtain such bonds because they are not "bondable." Those, of course, are the very contractors that shouldn't be in the home improvement business to begin with. If such a provision were enacted, the marketplace would react and surety companies would be willing to write such bonds and would find ways in the underwriting process to protect their interests. Specifically, sureties would take a more active participation in the projects that they bond for small contractors to insure that the money flows down from the contractor to the subcontractors, laborers, and suppliers. This would increase the cost of the bonds and thus the cost to the owner, but would provide the owner with much greater protection from defaulting original contractors. The cost of the bond would be much less than having to litigate and pay Mechanic's Liens.

The costs associated with the proposed statute in terms of the amount it would cost a typical homeowner for attorney's fees generated from the new legal issues raised by the proposed amendment *outweigh* the costs associated with a simple modification to the Mechanic's Lien law requiring that such projects be undertaken only with payment and performance bonds in place. Thus, by this modification to the Mechanic's Lien law, the legislature could more effectively address the double payment problem than by a more drastic amendment to the Mechanic's Lien law. As noted above, the Contractor's State License Board is opposed to AB 742. The CSLB is currently considering alternatives called the Home Improvement Plan for the year 2000 (HIPP 2000).[12] It is recommended that Items 1, 2, 4, 5, 6, 7, and 8 set forth on page 24 of the Exhibit be adopted and particularly the new mini performance bond (new Business and Professions Code Section

12. The alternatives are listed in Exhibit p. 24, and discussed in the pages following.

7071.55, as proposed by the Association of California Surety Companies) be adopted if a full performance and payment bond requirement be deemed too drastic. The mini bond proposal would double the dollar amount available to homeowners in bond protection.[13] This would protect owners of most home improvement projects. This proposal is vastly superior to the drastic and expensive procedures set forth in AB 742.

In light of the foregoing, it is recommended that rather than substantially amending the entire concept of the Mechanic's Lien law, that if a change is perceived to be necessary, that it be in the form of a mandatory bonding provision on private works of improvement where the improvement is an improvement to an single-family, owner-occupied residence requiring mandatory bonding on such projects as has been recommended by the CSLB.

3. Proposal That an Owner Be Required To Notify by Registered or Certified Mail the Original Contractor and Any Claimant Who Has Provided a Preliminary 20-Day Notice That a Notice of Completion or Notice of Cessation Has Been Recorded Within 10 Days of the Recordation of Such a Notice of Completion or Notice of Cessation.

Assembly Bill 171 would require the owner of a public or private work of improvement to notify by registered or certified mail the original contractor and any claimant who has provided a Preliminary 20-Day Notice that a Notice of Completion or a Notice of Cessation has been recorded within ten days of the recordation of such a Notice of Completion or Notice of Cessation.[14] This is an additional statute that was commented upon at the hearing of November 30, 1999. Essentially, the proponents of said legislation contend that the owner of a private or public work of improvement should be required to notify the original contractor and any claimant who has provided a 20-Day Notice that a Notice of Completion or Notice of Cessation has been recorded. This legislation has been submitted on the basis that it is difficult for the claimants on public and private works of improvement to determine whether or not a Notice of Completion or a Notice of Cessation of labor has been recorded. As noted in Part 1 of this Report, the original contractor must record its lien or serve its Stop Notice on private works of improvement within sixty days of recordation of a Notice of Completion or Notice of Cessation, and the subcontractors and material suppliers must record their Mechanic's Liens or serve their bonded Stop Notices on private works of improvement within thirty days of the recordation of a Notice of Completion or Notice of Cessation of labor. The Notice of Completion or Notice of Cessation is, of course, recorded in the office of the County Recorder in the county in which the real property is located. Many original contractors, subcontractors and material suppliers are small companies who do not have the ability or expertise to monitor

13. See Exhibit p. 27.

14. For the text of AB 171, see Exhibit pp. 64-66.

the recordings in the County Recorder's office to determine that a Notice of Completion or a Notice of Cessation has been recorded. Thus, the proponents of this bill assert that when the owner has received a Preliminary Notice from a potential claimant, the owner has knowledge of the fact that it has, in fact, recorded a Notice of Completion or a Notice of Cessation and the owner therefore should, in turn, advise the potential claimants that such a Notice of Completion or Notice of Cessation has been recorded so that the claimants may know that their time for recording liens or service Stop Notices is currently running.

The arguments in opposition to this proposed legislation are that it imposes an unfair burden on owners (particularly individual homeowners) that should not be imposed. The opponents of this legislation argue that claimants should have the obligation to monitor the recordings in the County Recorder's office to determine when a Notice of Completion or Notice of Cessation has been recorded so that they will know that their period for filing claims is running.

Your consultant believes that AB 171 would be beneficial. The claimants, on the one hand are obligated to furnish the owner, contractor and construction lender with a Preliminary Notice by personal service, registered mail or certified mail and therefore the owner is on notice of who the potential claimants are on the project. The owner, in turn, records the Notice of Completion or Notice of Cessation of labor when the project is completed and only the owner knows that it has done so. The claimants' time for recording its Mechanic's Lien or serving its Stop Notice commences to run upon the recordation of the Notice of Completion or Notice of Cessation of labor. It is an extremely short period of thirty days. Requiring the owner to notify the claimants that their time for recording a lien or serving a Stop Notice is running does not seem to be an unreasonable burden upon the owner.

EXHIBIT

to

Report to Law Revision Commission Regarding

Recommendations for Changes to the Mechanic's Lien Law

[Part 2]

Assembly Constitutional Amendment No. 5

Introduced by Assembly Member Honda

December 16, 1998

Assembly Constitutional Amendment No. 5—A resolution to propose to the people of the State of California an amendment to the Constitution of the State, by amending Section 3 of Article XIV thereof, relating to mechanic's liens.

LEGISLATIVE COUNSEL'S DIGEST

ACA 5, as introduced, Honda. Mechanic's liens.

The California Constitution provides that mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of the labor done and material furnished.

This measure would create an exception to that provision where the property is a single-family, owner-occupied dwelling that is the primary residence of the owner of the property if the owner has paid in full, to the person to whom the owner is contractually obligated to make payment, the amount owed by the owner for the labor bestowed and material furnished upon that property that would form the basis for the claim of lien.

Vote: $^2/_3$. Appropriation: no. Fiscal committee: no. State-mandated local program: no.

Resolved by the Assembly, the Senate concurring, That the Legislature of the State of California at its 1999–2000

Regular Session commencing on the seventh day of December 1998, two-thirds of the membership of each house concurring, hereby proposes to the people of the State of California that the Constitution of the State be amended by amending Section 3 of Article XIV thereof, as follows:

SEC. 3. ~~Mechanics~~ *(a) Except as provided in subdivision (b), mechanics*, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and material furnished; and the Legislature shall provide, by law, for the speedy and efficient enforcement of ~~such~~ *those* liens.

(b) A person described in subdivision (a) shall not have a lien upon any single-family, owner-occupied dwelling that is the primary residence of the owner of the property if the owner has paid in full, to the person to whom the owner is contractually obligated to make payment, the amount owed by the owner for the labor bestowed and material furnished upon that property that would form the basis for the claim of lien.

O

ASSEMBLY BILL No. 742

Introduced by Assembly Member Honda

February 24, 1999

An act to add Chapter 6.6 (commencing with Section 3079) to Part 4 of Division 3 of the Civil Code, relating to residential liens.

LEGISLATIVE COUNSEL'S DIGEST

AB 742, as introduced, Honda. Residential liens.

An existing provision of the California Constitution establishes a lien upon property upon which mechanics, persons furnishing materials, artisans, and laborers have bestowed labor or furnished material for the value of such labor done and material furnished.

This bill would prohibit, contingent upon enactment of a specified amendment to the above-described provision, a person, other than a contractor, as defined, who provides labor, materials, or services to an owner-occupied residential work of improvement pursuant to a contract entered into on and after January 1, 2000, with a contractor, from recording a lien upon that real property for the value of that labor, material, or service if the owner has paid the contractor in full.

The bill would also establish a Contractor Default Recovery Fund, which, upon appropriation, would provide funds for the purpose of providing monetary relief to a person who provides labor, materials, or services to a residential work of improvement and is not provided adequate compensation

therefor because the contractor is in default for payments therefor.

Vote: majority. Appropriation: no. Fiscal committee: no. State-mandated local program: no.

The people of the State of California do enact as follows:

SECTION 1. Chapter 6.6 (commencing with Section 3079) is added to Part 4 of Division 3 of the Civil Code, to read:

CHAPTER 6.6. CONTRACTOR DEFAULT RECOVERY

3079. (a) A person, other than a contractor, who provides labor, materials, or services to an owner-occupied residential work of improvement pursuant to a contract entered into on and after January 1, 2000, with a contractor to provide the labor, materials, or services, may not record a lien upon that real property for the value of that labor, materials, or services if the owner has paid the contractor in full pursuant to a contract between the owner and the contractor.

(b) For purposes of this chapter, a "contractor" is a person who has a direct contractual relationship with the owner of owner-occupied residential property to provide labor, materials, or services toward a work of improvement on that property.

3079.2. There is hereby established a Contractor Default Recovery Fund, which, upon appropriation therefor, shall be available for the purpose of providing monetary relief to any person, other than a contractor, who provides labor, materials, or services to a residential work of improvement and is not provided adequate compensation for this labor, material, or service because a contractor is in default to that person for payments that are owed for that labor, materials, or services.

3079.3. In order to establish a claim from the Contractor Default Recovery Fund, a person who provides labor, materials, or services to an owner-occupied residential work of improvement

pursuant to a contract entered into on and after January 1, 2000, with a contractor shall be registered to recover from the fund.

3079.4. It is the intent of the Legislature to develop a system of fees to fund the Contractor Default Recovery Fund and a system of registration to determine eligibility of a person to recover from the fund.

SEC. 2. This act shall only become operative upon the enactment of an amendment to Section 3 of Article XIV of the California Constitution to authorize the owner of residential real property to claim a defense against the recording of a mechanic's lien against the property by a subcontractor when the owner pays the contractor in full for the labor, materials, or services on which the lien is based.

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Date of Hearing: May 11, 1999

ASSEMBLY COMMITTEE ON JUDICIARY
Sheila James Kuehl, Chair
ACA 5 (Honda) - As Introduced: December 6, 1998

SUBJECT: MECHANIC'S LIENS: HOMEOWNER PROTECTION

KEY ISSUE: SHOULD THE CALIFORNIA CONSTITUTION BE AMENDED TO CREATE AN EXCEPTION TO THE MECHANIC'S LIEN LAW IN ORDER TO PROTECT HOMEOWNERS WHO HAVE PAID THE GENERAL CONTRACTOR IN FULL?

SUMMARY: Creates an exception to the constitutional mechanic's lien provision to protect homeowners who have paid the general contractor in full for a home improvement project. Specifically, this bill: proposes to the people of the State of California that Section 3 of Article 14 of the California Constitution be amended to exempt from the mechanic's lien provision "any single-family, owner-occupied dwelling that is the primary residence of the owner of the property if the owner has paid in full, to the person to whom the owner is contractually obligated to make payment, the amount owed by the owner for the labor bestowed and material furnished upon that property that would form the basis for the claim of lien."

EXISTING LAW:

1) Provides that certain persons have a mechanic's lien upon property upon which they have bestowed labor or furnished materials in the amount of the value of labor done and materials furnished. (Calif. Const., Art. 14, Section 3.)

2) Provides for the creation and enforcement of mechanic's liens and generally governs payment provisions contained in contracts for works of improvement. (Civil Code Section 3109 et seq. All further statutory references are to this code unless otherwise stated.)

3) Provides that a contractor or material supplier is entitled to enforce a mechanic's lien against property only if he or she has given preliminary notice in accordance with the mechanic's lien law, and that strict compliance with the preliminary notice provision is required. (Kim v. J.F. Enterprises (1996) 42 Cal.App.4th 849, 855.)

4) Provides that a contractor or material supplier on a private work of improvement must file a preliminary notice with the owner, general contractor, and construction lender within 20 days of providing the labor or furnishing the materials, prior to the recording of a mechanic's lien, prior to the assertion of any claim against a payment bond, or prior to the filing of a stop notice. (Section 3097.) A similar 20-day preliminary notice requirement applies to contractor claims in public works projects. (Section 3098.)

5) Provides that any person who has filed a preliminary 20-day notice may file such notice with the county recorder in the county in which the property is located, and that the county recorder shall mail to those persons notification that a

notice of completion or notice of cessation has been recorded on the property. (Section 3097(o) (1) .) Also provides that the county recorder shall make a good faith effort to mail such notification within five days after the recording of a notice of completion or notice of cessation. (Section 3097(o) (2) .) However, the failure of the county recorder to mail the notification to the person who filed a preliminary 20-day notice, or the failure of those persons to receive the notification or to receive complete notification, shall not affect the time period within which a claim of lien is required to be recorded. (Section 3097(o) (3) .)

6) Provides that when a property owner records a valid notice of completion or notice of cessation:

   a) An original (general) contractor in direct contract with the owner must record his or her lien and/or serve a stop notice within 60 days of the recording of the notice of completion or notice of cessation. (Section 3115.)

   b) All other claimants must record their liens and/or serve stop notices within 30 days of the date of the notice of completion or notice of cessation. (Section 3116.)

7) Provides that where no notice of completion or notice of cessation has been recorded by the property owner, but the project has actually been completed, all claimants must record their liens and/or serve stop notices within 90 days from the date of actual completion. (Sections 3115, 3116.)

COMMENTS: According to the author, ACA 5, and its companion measure, AB 742, seek to end the victimization of homeowners, subcontractors, material suppliers and laborers, by unscrupulous prime contractors. This measure proposes an amendment to the State Constitution which would create an exception to the mechanic's lien provision where the homeowner has paid in full the amount owed to the general contractor for the labor bestowed and material furnished upon the property that would form the basis for the claim of the lien. ACA 5 applies only where the subject of the lien is a single-family, owner-occupied dwelling that qualifies as the primary residence of the owner and the homeowner has fully performed his or her contractual obligations.

Background. As noted above, a mechanic's lien is the current legal mechanism available to protect the interests of those who provide labor or materials toward the improvement of the property of others, known as a "work of improvement." A brief overview of the mechanic's lien statutes and case law is set out below.

Brief Overview of Mechanic's Lien Statutes. The basic right to a mechanic's lien was first guaranteed by our State Constitution in 1879, and remains in effect today:

> "Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and material furnished; and the Legislature shall provide, by law, for

> the speedy and efficient enforcement of such liens." (Cal. Const., art. XIV, sec. 3.)

A mechanic's lien is a claim against the real property on which the claimant has furnished labor or material, for the value of the labor done or material furnished. It gives the person that has furnished services, equipment, or material for a work of improvement a security interest in the improved real property that may be foreclosed upon if the claim is not paid. The major classifications of those who are entitled to a lien are contractors, subcontractors, material suppliers, artisans and laborers. The lien must be recorded within the applicable time period specified by law, in the county in which the property is located.

After being properly recorded, a lien binds the property for no longer than 90 days, unless a foreclosure action is filed. Thus, the contractor or supplier must file a lawsuit within 90 days to foreclose on the lien. The property owner can then defend itself in that lawsuit. The ultimate remedy under the lien is to have
the property sold to satisfy the claim. If the claimant fails to bring an action to enforce the lien within 90 days, then the owner of the property, or anyone with an interest in the property, may petition the court for a decree to "release the lien" on the property and for attorney's fees and costs.

Timelines for Filing Mechanic's Liens. No statute requires a property owner to file and record a notice of completion of the project. However, if the owner records a timely notice, he or she obtains the benefit of a shorter lien-filing period. (Fontana Paving, Inc. v. Hedley Brothers, Inc. (1995) 38 Cal.App.4th 146, 154.) As noted above, a contractor or material supplier is entitled to enforce a mechanic's lien against property only if he or she has given preliminary notice in accordance with the mechanic's lien law. (Kim v. J.F. Enterprises (1996) 42 Cal.App.4th 849, 855.) When a property owner records a valid notice of completion or notice of cessation, the original (general) contractor in direct contract with the owner must record his or her lien and/or serve a stop notice within 60 days of the recording of the notice of completion or notice of cessation (section 3115) ; subcontractors and all other claimants must record their liens and/or serve stop notices within 30 days of the date of the notice of completion or notice of cessation. (Section 3116.)

Brief Overview of Case Law. In Connolly Development, Inc. v. Superior Court (1976) 17 Cal.3d 803, the California Supreme Court upheld the constitutionality of the mechanic's lien and stop notice remedies, noting: "The California Constitution explicitly recognizes the importance of the protection of the claims of the mechanic and materialmen; no other 'creditor remedy' in this state enjoys such a constitutionally protected status." The Connolly court also noted that the courts have liberally construed California's mechanic's lien laws:

> "The mechanic's lien is the only creditors' remedy stemming from constitutional command and our courts 'have uniformly classified the mechanics' lien laws as remedial legislation, to be liberally construed for the protection

> of laborers and materialmen.' [Citation.]" (Hutnick v. United States Fidelity & Guaranty Co. (1988) 47 Cal.3d 456, 462.) "[S]tate policy strongly supports the preservation of laws which give the laborer and materialmen security for their claims." (Connolly , supra , 17 Cal.3d at 827.)

Still, the constitutional mechanic's lien provision "is not self-executing, and is inoperative except as supplemented by legislation." (Borchers Bros. v. Buckeye Incubator Co. (1963) 59 Cal.2d 234, 237-238.) The Legislature has the power "'reasonably to regulate and to provide for the exercise of the right, the manner of its exercise, the time when it attached, and the time within which and the persons against whom it could be enforced.'" (Borcher Bros. , supra , 59 Cal.2d at 238, quoting Barr Lumber Co. v. Shaffer (1951) 108 Cal.App.2d 14, 20, italics in original.)

In Industrial Asphalt, Inc. v. Garrett Corp. (1986) 180 Cal.App.3d 1001, 1006-1007, the court described the purpose of the mechanics' lien law as follows:

> "Ancient authority enunciates the purpose of the mechanics' lien: to prevent unjust enrichment of a property owner at the expense of a laborer of material supplier. 'The principle upon which liens are allowed in favor of mechanics and material-men is, that their labor and materials have given value to the buildings upon which they have been expended, and that it is inequitable that the owner of land, who has contracted with them for such improvement, or who has stood by and seen the improvement in progress without making objection, should have the benefit of their expenditures without making compensation therefor.' (Avery v. Clark (1891) 87 Cal. 619, 628.)
>
> The traditional policy favoring the laborer or material supplier presupposes that their interest differs substantively from that of creditors, whose interest in real property or chattel remains essentially pecuniary. The laborer or material supplier has invested his labor, or added materials originally in his possession, to improve property of another and increase its value. They thus 'have, at least in part, created the very property upon which the lien attaches. ?' [Citations omitted.]"

Generally, doubts concerning the meaning of the mechanics' lien statutes are resolved in favor of the claimant. (Coast Central Credit Union v. Superior Court (1989) 209 Cal.App.3d 703, 711.)

However, "lien laws are not to be applied blindly without regard to the rights of property owners." (Baker v. Hubbard (1980) 101 Cal.App.3d 226, 233.) In Borcher Bros. , our Supreme Court approved the language of Alta Bldg. Material Co. v. Cameron (1962) 202 Cal.App.2d 299, 303-305, as follows:

> "While the essential purpose of the mechanics' lien statutes is to protect those who have performed labor or furnished materials towards the improvement of the property of another [citation], inherent in this concept is a recognition also of the rights of the owner of the benefited property. It has been stated that the lien laws

> are for the protection of property owners as well as lien claimants [citation] and that our laws relating to mechanics' liens result from the desire of the Legislature to adjust the respective rights of lien claimants with those of the owners of property improved by their labor and material."

The Supreme Court recognized that "liens often result from activities of third parties over which the owner has no control and of which he may be unaware." (Baker v. Hubbard , supra , 101 Cal.App.3d at 234.)

I. The Problem. The author describes the problem as follows:

Step One: The homeowner enters into an contract with a prime contractor for a home improvement project. The prime contractor hires laborers and subcontractors, and purchases supplies from a material supplier. Upon completion of the project, the homeowner pays the prime contractor in full, but the prime contractor fails to pay the laborers, subcontractors, and material suppliers.

The victims here are the laborers, subcontractors, and material suppliers who are not paid. They are victimized by a broken promise - a prime contractor who does not honor his or her contracts with the laborers, subcontractors, or material suppliers.

Step Two: Under current law, once the laborers, subcontractors, and materials suppliers have failed to be paid by the prime contractor, each party who has not been paid has the right to collect from the homeowner via a mechanic's lien. According to the author, this right to collect from the homeowner makes sense when the homeowner hasn't paid the prime contractor. However, it doesn't make sense if the homeowner has paid the contractor in full.

The author believes that the innocent homeowner, who is forced to pay twice, because the prime contractor did not honor his or her contracts with the laborers, subcontractor, or material suppliers is the victim in this situation. The reason the homeowner is victimized is not due to a broken promise on the part of the homeowner, but rather by operation of the mechanic's lien laws.

According to the author, "it is important to recognize at this point that the sole person at fault in this hypothetical is the unscrupulous prime contractor. There is no dispute that laborers, subcontractors, and material suppliers should be paid, but the homeowner shouldn't be forced to pay twice."

II. The Solution. The challenge, according to the author, is to design a carefully tailored solution which will protect both the innocent homeowner and laborers, subcontractors or material suppliers.

Step One -- To Protect the Laborer, Subcontractor or Material Supplier: On the premise that the laborers, subcontractors or material suppliers are victims of the unscrupulous contractor, is it possible for our laws to insure that laborers,

subcontractors, and material suppliers are paid without victimizing innocent homeowners?

According to the author, fifteen states have answered "Yes" and have created industry supported funds to pay laborers, subcontractors, and material supplier. Some of these funds have been in operation for more than 15 years. These states have concluded that a just law in this area must distinguish between those who have done wrong and those who have not. The laws of these states reflect the policy that an innocent homeowner should not have to pay twice.

This bill, ACA 5, is a companion measure to AB 742, which will create a Contractor Default Fund that is modeled after the state of Utah's statutes in this area. Laborers, subcontractors, and material suppliers who are victimized by an unscrupulous prime contractor would seek payment from this new California subcontractor protection fund, when homeowners meet the conditions prescribed below.

Step Two -- To Protect the Innocent Homeowner: The second part of the solution being proposed by the author is to remove the burden from homeowners who are free from wrongdoing. According to the author, this bill, ACA 5, proposes narrowly tailored amendments to the California Constitution which retain the burden of payment on those homeowners who are guilty of wrongdoing, but provides relief to those who are innocent. "ACA 5 recognizes that mechanic's lien laws originate through application of the legal concept of 'unjust enrichment.' Where the homeowner has not paid, the homeowner is unjustly enriched. ACA 5 does not impact the rights of laborers, subcontractors or material suppliers in these cases. ACA 5 only applies when homeowners have paid the negotiated price for the home improvement in-full."

The author contends this second part of the solution is a narrow one: "ACA 5 only focuses on home improvement transactions, not commercial or non-residential transactions. Looking at the class of all home improvement transactions, we have narrowed our proposal to transactions only involving homes which are single family residences. To further limit the application of ACA 5, it only impacts owner-occupied homes."

Staff Comment. Notwithstanding the understandable and predictable opposition from many subcontractor organizations and businesses, this legislation appears to offer a narrowly-crafted solution to an unfair situation often facing California homeowners. Though both sides to this heated debate have strong arguments, the Committee may conclude that the adage "two wrongs don't make a right" appears most apt here, and may choose to provide this new and substantial protection to the state's homeowners.

ARGUMENTS IN SUPPORT: The American Association of Retired Persons (AARP) supports ACA 5, stating that it would "correct the double jeopardy homeowners face when they contract to remodel or repair their homes." According to AARP, "[e]xisting law rewards subcontractors who negligently or even willfully extend credit to general contractors they know to be 'flaky' or insolvent since [current] law shifts all risk to the homeowner,

even if the homeowner has already paid in full. [Under this system], subcontractors and suppliers have no incentive to exercise reasonable care."

The Congress of California Seniors also supports the bill, stating that "homeowners are caught between the contractor and the subcontractor and shouldn't have to bear the financial burden of another party's irresponsibility."

The League of California Homeowners strongly supports the bill, stating that it "will provide significant protection to homeowners, especially senior citizens, from abuse by unscrupulous contractors. ? Too many remodeling contractors with bad credit are allowed to hurt unsuspecting homeowners by not paying their bills even though their own contract was paid in full. If ACA 5 becomes law, then the construction industry will clean itself up by requiring better credit performance of prime contractors before extending credit. Senior citizens, homeowners with English language limitations and an unsuspecting public in general will be the winners?. It is time that we end this archaic form of institutionalized double jeopardy."

The Western Center on Law and Poverty and the California Rural Legal Assistance Foundation also support the measure, stating that "[s]ubcontractors and suppliers are in a business relationship with contractors. They have other means of redress rather than holding a homeowner hostage. This special status is not accorded other suppliers. For example, an automobile parts company is not allowed to put a lien on a consumer's car if the mechanic who installed the parts fails to pay the parts company.

There is no logical basis for building suppliers to be treated differently."

The Little Branham Rosswood Neighborhood Association supports ACA 5, writing that "[h]omeowners are not insurance companies. They hire and pay contractors in good faith. Whether or not the contractor continues the good faith with his suppliers or laborers cannot be the responsibility of the homeowner. ? Even with the best checks that a homeowner can make when hiring a contractor, it is more reasonable to expect the subcontractors to be familiar with the reputation of a contractor than the homeowner. The industry could cleanse itself of unscrupulous contractors if the burden of responsibility was shared with the subcontractor who would refuse to work for those who have questionable reputations."

The California Land Title Association (CTLA) also supports the bill, stating that once a mechanic's lien is recorded, the real property owner now has the burden of contesting the lien. "Unfortunately, some real property owners simply pay the mechanic's lien amounts (even if invalid) because it is cheaper than litigation to prevent the foreclosure of the lien. Unlike general and subcontractors, all other creditors seeking a lien are forced to go through a judgment lien process which requires a court hearing before the judgment lien may be recorded against the property. This affords the real property owner due process rights that are not provided under the mechanic's lien law."

CTLA contends that "most residential property owners are not sophisticated enough in real property law to understand how the

mechanics' lien process works or how best to protect themselves.

They assume, with good reason, that their general contractor will coordinate all aspects of their project, do good work, as well as pay all subcontractors on a timely basis. They should not also be in the position of having to make sure the general and subcontractors are doing the job they are being paid to do. ? ACA 5 would be a positive step in the right direction by protecting residential property owners from the inherent unfairness of the mechanics' lien law."

The Surety Company of the Pacific (SCP) , which is the largest writer of contractors' license bonds in California, also supports ACA 5. SCP states that more than half of the claims they process are filed by materialmen or suppliers who have not been paid by the principal contractor for supplies or services rendered for a home improvement. SCP notes that when a contractor has failed to pay for supplies and subcontractor services, "it is the result of mismanagement by the principal contractor." The contractors' license bond, which is statutorily set at $7500, "can be exhausted before all parties claiming on the bond are fully satisfied. In these instances, the materialmen and/or subcontractor will then record a lien on the homeowner's property."

According to SCP, "material suppliers and subcontractors can take steps to protect themselves, and thereby avoid situations where they go unpaid by a wayward contractor. For example, both the subcontractor and materialman can provide their supplies and services on a COD basis. They can also operate on a progress payment basis where the amount of work they perform or materials they supply are provided in increments along with progress payments. Both of these precautions would prevent the homeowner [from] being responsible for substantial payments owed by the principal contractor. Yet, it is SCP's experience, that in their zeal to compete for work, many material suppliers and subcontractors do not appropriately protect themselves. Perhaps they feel that the ability to record a mechanic's lien will always be there to bail them out, to the detriment of the homeowner."

If ACA 5 amends the Constitution to place a limit on the circumstances under which a lien can be recorded, SCP believes that "material suppliers and subcontractors would have an incentive to apply these other methods to protect themselves[.] In addition, this would help to reduce the number of claims against a particular contractor's license bond, so that a greater share of the bond would be available for homeowners if a contractor's violation of the license law harms them, and the homeowner wishes to claim against the bond."

ARGUMENTS IN OPPOSITION: This measure is opposed by over 100 subcontractors and material supply companies, as well as various statewide trade organizations and associations representing these interests. A summary of some of their principal arguments is set out below.

Opponents contend that mechanic liens are a very important mechanism to the construction process. They state that it is unfair that the subcontractor, who often has less means than the homeowner, should suffer the loss of their labor and materials,

when the homeowner benefits from the fruits of their labor. Opponents believe that homeowners need to be better educated regarding the construction process as well as their potential liabilities, and that requiring the laborers to shoulder the risk of loss because the general contractor failed to pay them does not solve the problem.

According to opponents, this measure is unnecessary since there are many protections for homeowners already in statute that address the concerns raised by ACA 5. These protections are referenced in the "notice to owner" which mentions the possibility of requiring payment bonds, payments directly to subcontractors or material suppliers, joint checks and "waiver and release" forms from suppliers and subcontractors when their portion of the work is completed and payment is made. (See e.g., Business & Professions Code Section 7018.5.)

Similarly, opponents note that a homeowner may require a contractor to provide a payment bond for 50% of the contract amount. If the owner then records both the contract and the payment bond, the law protects the property owner against possible mechanic's liens. (See Civil Code Sections 3132, 3235, 3236.) This approach limits the lien claim recovery to the amount the owner still owes the original contractor; if the owner has paid the contractor in full, then there is no lien recovery.

Opponents also complain that it is unclear how ACA 5 would work.

"If a subcontractor or supplier has not been paid and in fact records a lien, would a court have to adjudicate whether the owner has indeed paid in full for work or materials? If so, all the parties would still bear the expense and time involved in litigating this issue. Other collateral issues the court may have to address would be whether there is any possible collusion between the contractor and owner that may deny the subcontractor and suppliers compensation for their work or materials."

Opponents state that the homeowner selects the prime contractor and should take primary responsibility for determining whether he or she is reliable. They contend that, "unlike homeowners, subcontractors, laborers, or materialmen have few effective legal remedies to recover moneys owed to them by a prime contractor who fails to pass along payments from the owner. Litigation against the prime contractor is expensive and often unproductive because the prime contractor lacks assets to pay a judgment."

"[S]ince contractors provide an owner with a notice that says they can lien their property if they're not paid, why isn't that sufficient for the owner to read it and make payments payable to both the prime contractor and subcontractor, or secure a release from the subcontractor, or simply call the prime contractor and ask for a breakdown of costs and write separate checks?"

Opponents also emphasize that the mechanic's lien law is a fundamental worker protection. This constitutional protection, which has been in effect for over 100 years, should not be changed to address a few situations where the owner did not properly fulfill his own responsibilities. They claim there is no evidence that the situation that ACA 5 is seeking to address

is a widespread problem warranting amending the State Constitution.

They also argue that the economic impact of ACA 5 would hurt the very persons it is designed to protect. According to opponents, without the protection of the mechanic's lien law, many subcontractors and suppliers would refuse to bid on or work on those types of projects. In addition, contractors and subcontractors would find it very difficult to find material suppliers that would extend credit to them on such projects. By reducing the number of contractors and subcontractors either able or willing to work on these projects would drive up the costs of those projects to the homeowner.

Finally, a number of the opponents suggest that the whole area of mechanic's lien law is confusing, and is a topic that is ripe for reference to the California Law Revision Commission. "With over $25 billion in construction activity each year in California, the importance this area of the law has in governing a critical component of the state's commerce should not be addressed on an ad hoc basis."

Pending related legislation. AB 742 (Honda) , described above, which is also scheduled to be heard by the Committee on May 11, 1999.

REGISTERED SUPPORT / OPPOSITION:

Support

American Association of Retired Persons
Beverly Hills/Greater Los Angeles Association of Realtors
California Apartment Association
California Association of Mortgage Brokers
California Land Title Association
Cambrian Community Council
Congress of California Seniors
Consumers Union
League of California Homeowners
Little Branham Rosswood Neighborhood Association
Marin Association of Realtors
San Jose Real Estate Board
Southern Alameda County Association of Realtors
Southland Regional Association of Realtors
Surety Company of the Pacific
Western Center on Law and Poverty
Various individuals

Opposition

ABC Supply Co., Inc.
Ace Brick & Patio
Ace Roofing Material
Adobe Lumber
Advance Overhead Door, Inc.
A-G Sod Farms, Inc.
Alameda Electrical Distributors, Inc.
A.L.L. Roofing and Building Materials Corporation
All Temperatures Controlled, Inc.
American Transit Mix Co., Inc.

Angelus Block Co., Inc.
Arcadia, Inc.
Associated General Contractors of California
Bay Cities Building Materials Co., Inc.
B&B Red-I-Mix Concrete, Inc.
B&C Custom Hardware and Bath
Beronio Lumber
Blake Air Conditioning & Service Co., Inc.
Bogner Sheet Metal
Builders Concrete, Inc.
Builders Disbursements, Inc.
Builders Supply Company, Inc.
Building Industry Credit Association
Building Industry Credit and Supply Coalition
Calaveras Materials Inc.
California Association of Sheet Metal and Air Conditioning Contractors, National Association
California Builders Exchanges
California Building Industry Association
California Fence Contractors' Association
California Landscape Contractors Association
California Legislative Conference of the Plumbing Heating and Piping Industry
California Rental Association
California Shingle & Shake Company
California Spa and Pool Industry Education Council
California State Association if Electrical Workers
California State Pipe Trades Council
Cal-State Steel Corp.
Cameron Ashley Building Products
C.A. Schroeder, Inc.
Central Valley Builders Supply
Central Valley Hardware Co.
Chandler's
Cloutier-Lott Enterprises, Inc.
Cole Services
Concrete Ready Mix, Inc.
Consolidated Electrical Distributors, Inc.
Construction Employers' Association
Construction Industry Legislative Council
Contractors Building Materials
Contractors Wardrobe
County Lumber Company, Inc.
Credit Managers Association of California
Crenshaw Lumber Co.
Dos Palos Lumber and Sales
ECCO Equipment Corporation
Electrical Distributors Co.
Elsinore Ready Mix Company, Inc.
Empire Lumber & Supply
Engineering Contractors' Association
Familian Pipe and Supply
Fleetwood Aluminum Products, Inc.
Gang-Nail Truss Company Inc., of Visalia
Golden Empire Concrete Co.
Golden State Fence Co.
Gregory Greenwood Construction
Heat and Cooling Supply, Inc.
Inland Concrete Enterprises, Inc.
Institute of Heating and Air Conditioning Industries, Inc.

J&W Redwood Lumber Co. Inc.
Jim's Supply Co., Inc.
KRC Rock Inc.
La Mesa Lumber Company
Los Banos Lumber and Sales Co.
Lumber Association of California and Nevada
Maltby Electric Supply Co., Inc.
Marin Builders' Exchange
Milgard Manufacturing, Inc.
Mitsuwa Nursery, Inc.
Monrovia
National Electrical Contractors Association, California Chapter
NES Mechanical Systems
Novato Builders Supply, Inc.
Oxnard Building Materials
Pacific Plastics
Pacific States Industries, Inc.
Pine Cone Lumber Co., Inc.
Prime Source Building Products, Inc.
Puente Ready Mix, Inc.
Rancho Ready Mix, Inc.
Rick Hamm Construction, Inc.
Robertson's
Roofing Contractors Association of California
Sacramento Builders' Exchange
Scheu Steel Supply Company
SIDS Air Conditioning, Inc.
Sierra Lumber & Fence
S.M. & Co.
Southdown Concrete Products, Inc.
Southern California Contractors' Association
Spragues' Ready Mix
Standard Concrete Products, Inc.
State Building and Construction Trades Council of California
State Ready Mix Inc.
Sunwest Materials
Thermal-Cool Heating & Air Conditioning
United Rentals
Viking Ready Mix Co., Inc.
Visalia Lumber Co.
Western States Council of Sheet Metal Workers
Various individuals

Analysis Prepared by: Daniel Pone / JUD. / (916) 319-2334

Contractors State License Board - Staff Analysis
Legislative Counsel Draft of Assemblyman Honda's Contractor Default Recovery Fund

Summary: This measure would create a recovery fund in CSLB for the purpose of reducing liens placed by subcontractors, material suppliers and laborers on the homes of California residents who have contracted for home improvement work and have paid their contractors in full.

Background: CSLB does not have information to determine how many liens are perfected after a contractor has paid in full. Consequently, CSLB has no basis to evaluate how effective a recovery fund would be at targeting this particular consumer.

Fiscal Impact: Major fiscal impact. CSLB would be responsible to administering the fund. Contractors that have the home improvement certification will be required to pay $200 annually into this fund. We estimate this will result in a fund that is approximately $50 million. The fund itself would pay for the cost of the hearing. CSLB would need a unit to administer, coordinate and audit this fund, however, as currently drafted there is no funding for CSLB's administration. Finally, the fund would create a whole new emphasis for enforcement as well as require new services from the AG.

Staff Recommendation: Oppose as drafted

Discussion of Fund

Who may claim?

Subcontractors, material suppliers, equipment renters or laborers may file a claim showing that:

- the prime was a licensed contractor and the contract was in writing
- the lien claimant (the sub etc.) recorded a lien
- the homeowner paid the contractor in full. "Paid in full" is specifically defined.
- the contractor failed to pay the lien claimant

Concern: The definition of "paid in full" contains a contradiction. "Paid in full" is defined as the value of the work. The code section also includes the statement that "a person shall not be considered to have been paid in full if 10 percent or more of any retention proceeds have been withheld." As written, this code section mixes together ideas of contract law (retentions) and laws of equity (reasonable value). Placing these two ideas in the same code section confuses the issues. Does the author want us to

use the contract dollar amount as the indication of "paid in full." Or should the reasonable value be used. If reasonable value is used, then retention figures do not apply. The issue that should be considered is not whether the contractor has paid in full but rather "Is there money left in the contract to pay the cost of the lien?"

Concern: Additional problems arise out of the paid in full requirement. The legislation targets consumers who have paid in full but are, nonetheless, subjected to liens. While these homeowners have been seriously harmed, many other consumers can demonstrate much worse injury. For example, the contractor hires a sub to rip the roof off. The homeowner pays the down payment and a progress payment. The contractor does not pay the sub and abandons the project. The sub files a lien. This homeowner would not qualify for the fund. Taking this idea a little further: The homeowner who becomes aware that the contractor is not paying his obligations may be placed in the position of throwing more money at the contractor in order to have paid in full or face being excluded from the fund.

Who Pays Into the Fund?

Contractors who hold a Home Improvement Certification will be required to pay $200 per year. This will result in almost $50 million the first year.

Concern: Subcontractors (who are also licensed contractors would pay into the fund) and then benefit from the fund. Material suppliers would, however, not pay into the fund but would benefit anyway.

What can be Paid from the Fund?

The present version provides funding for the hearing officer and for the value of the lien.

No individual claim can exceed $75,000. No individual claimant can be paid more than $500,000.

Concern: An earlier version of the bill provided that the fund could be used to pay the value of the lien, CSLB's administrative costs, hearing costs, including the cost of the hearing officer, the Attorney General's costs for bringing disciplinary action, including the appeal, and costs associated with getting reimbursement from the contractor. This version does not provide any additional funding to support the fund administration or the additional enforcement costs this kind of fund would generate.

Fund Requirements

At present, CSLB does not know how much money will be needed for the fund. Apparently about $50 million will be available each year.

The bill requires CSLB to annually determine how much will be needed each year as well as to audit the fund. No funding is provided to administer a fund this large.

What is the Process?

- Potential lien claimant provides copy of affidavit form to homeowner with preliminary notice
- Lien claimant records lien
- Homeowner prepares and records an affidavit within 30 days of notice that lien has been recorded.
- Lien claimant files a claim with the CSLB within 90 days of recording lien
- CSLB sends copies of claim to lien claimants claim to contractor and homeowner
- Contractor must respond in 15 days
- If no response, hearing officer makes a finding that contractor was paid in full and failed to pay the lien claimant. Hearing officer orders lien value paid to lien claimant.
- If the contractor responds, hearing held to determine if the contractor was paid in full and if the lien claimant has valid claim. If yes to both questions, the hearing officer orders payment from recovery fund and the contractor's license is automatically suspended. If no payment is ordered, the lien claimant may continue to pursue in superior court.
- If license suspended, a hearing will be held within 60 days pursuant to CSLB procedures. If the finding is sustained, license is revoked. The license may be reinstated only upon issuance of a $50,000 disciplinary bond.

Concern: Process is designed to only briefly interrupt the strict provisions that must be followed to perfect a lien. Claimants do not give up any rights in order to participate although they are required to give up rights in order to actually cash the check. This may result in two separate contradictory proceedings.

In a recovery fund action, the homeowner and lien claimant both claim the lien is proper because both are seeking a fund pay out for the subcontractor. If the claimant and homeowner fail to demonstrate the validity of the claim, however, the claimant still has a lien right. In the civil lien action, the homeowner must now switch positions and argue against the lien's validity.

Staff has concerns that the recovery fund proceeding may eliminate a homeowner's later arguments against lien validity. Dishonorable subcontractors could even manipulate the process so that a lien that could not have been perfected would be because the homeowner has lost his or her right to argue against the lien.

Role of CSLB

The Board administers the fund and may use it to pay the hearing officer and the value of the lien. No funds are provided for administration.

After the hearing officer orders payment from the fund an automatic suspension of the contractor's license ensues. The bill allows an appeal to be held. This appeal is to be based on CSLB procedures.

Concern: Even if a hearing is held based on CSLB procedures, the evidence provided in the recovery fund hearing may differ markedly from the evidence necessary to demonstrate contractor misconduct. Since CSLB will not have prosecuted the case, CSLB may have no basis on which to defend the contractor's suspension.

CSLB is responsible for seeking reimbursement from the contractor if a pay out is made.

Concern: There are no additional administrative funds provided to pay for this kind of prosecution.

Concern: For the same reasons discussed above (CSLB did not prepare the case before the fund hearing officer), CSLB may lack sufficient evidence to seek reimbursement.

Home Improvement Protection Plan 2000

Introduction

CSLB has identified homeowners contracting for home improvement work as the consumers most vulnerable to incompetent or untrustworthy contractors. Our complaints indicate that individual homeowners are not as able to assess the risk of contractor misconduct: the average homeowner may lack the knowledge and sophistication to determine if a contractor has both the technical skill and the fiscal expertise to adequately perform.

The Home Improvement Protection Plan 2000 (HIPP 2000) is a mix of consumer protection strategies designed to prevent and/or remedy harm to California homeowners who enter into home improvement contracts with licensed contractors.

Relation to Sunset Review

HIPP 2000 also responds to a question raised by the Sunset Review Committee: "Should the state consider other alternatives to providing restitution to the consumer . . .?" All the HIPP 2000 proposals can be considered alternatives (or, if the board so wishes, supplements) to a restitution fund.

HIPP 2000 Presentation

HIPP 2000 is divided into two parts. The first part of the HIPP 2000 presentation identifies the kinds of financial injury routinely caused by a small percentage of licensed contractors and suggests some incremental strategies for reducing that harm. We want direction from the Executive Committee about whether these strategies are consistent with the approach the Board wishes staff to pursue.

The second part addresses CSLB's need for data concerning the contractor licensee pool. We are designing a survey to acquire this data to create, if possible, a system wide approach to the prevention and remediation of financial injury.

Requested Executive Committee Action

Direct Staff to work with interested parties on the following incremental solutions to better protect consumers.

1. 2% penalty available in civil court to unpaid material suppliers.

2. Revise present Notice to Owner to become a "Mechanic's Lien Warning".

3. Revise 20-Day Preliminary Notice to become 5-Day Notice prior to starting project.

4. New legislation addressing Contractor's Failure to Provide Notice.

5. Revise Home Improvement Notice Statute

6. Require Disclosure of General Liability Insurance Status.

7. Draft new brochure "Don't Lien on Me".

8. Criminal Conviction Regulations and Legislation

HIPP 2000

HIPP 2000: Three Categories of Proposed Incremental Solutions

1. New Remedies
2. Improved Consumer Information/Disclosure
3. Enhanced Consumer Protection Through Criminal Conviction Review

New Remedies

- New mini-performance bond (new B&P 7071.55 as proposed by Association of California Surety Companies)
- 2% penalty available in civil court to unpaid material suppliers (new B&P 7108.6)
- Consequential Damage Remedy: Mandate General Liability Insurance (AB 1288)

Improved Consumer Information/Disclosure

- Present Notice to Owner revised as "Mechanic's Lien Warning" (CSLB's proposed amendment to SB 1151 sponsored by Surety of the Pacific)
- (20 day) Preliminary Notice provisions revised to change timing of notice (5 day prior to start) and to make the notice more readable (Civil Code 3097.2)
- New legislation proposed addressing contractor's failure to provide required notice (new B&P 7159.3).
- Home Improvement Notice Statute revised to separate the notice requirements from other contractor requirements (B&P 7159).
- New legislation proposed to mandate disclosure of General Liability Insurance (GLI) Status

- New Brochure, "Don't Lien On Me," created to address lien issues.(We are working on this brochure. Draft to Contractor and Consumer Education Committee at October Board Meeting).

Enhanced Criminal Conviction Review: Follow-up from July meeting

- Proposed Legislation
- Proposed Regulation

Additional HIPP 2000 proposals

- Proposed Study to identify feasibility of systems approach to the prevention and/or remediation of financial injury

New Remedy
Mini-Performance Bond

- Doubles dollar amount available to homeowners in bond protection.
- Accessed by homeowner only (subcontractors and/or material suppliers can be paid through homeowner's complaint)
- Expands the basis for bond payout to require only damage to homeowner, not a violation of Contractors State License Law.
- Pays out on arbitration awards.
- Requires contractors working in home improvement to carry the new bond. Other contractors do not participate.
- May provide an effective alternative to a recovery fund. Unlike the recovery fund proposed by Assemblyman Honda, which is funded by all contractors, the mini-performance bond is paid for by the individual contractor to cover his or her own imprudence.

Description

This legislative proposal was developed by the Association of California Surety Companies. A representative of this association will appear at the Executive Committee meeting to discuss this proposal.

New Remedy

2% Penalty Obtainable in Civil Court for Unpaid Material Suppliers (Propose New B&P Section 7108.6)

Purpose of New Legislation:

- Creates same protection for material suppliers and equipment renters as given subcontractors under B&P section 7108.5 by providing a 2% per month penalty for a contractor's failure to pay when paid.

- Provides **alternative to a proposed lien recovery fund** in that it enables material suppliers to seek a judgment in civil court including both the amount due and a 2% penalty from the contractor. Material suppliers may opt to use this in lieu of pursuing lien.

- Clarifies that the 2 % penalty is designed as a remedy to be ordered in civil court and not as part of a disciplinary procedure.

- Adds a new cause for disciplinary action even though CSLB will not order the 2% penalty.

Discussion

This new code section does for material suppliers what Business & Professions Code section 7108.5 does for subcontractors. B&P code 7108.5 targets prime contractors who fail to timely pay subcontractors by making the prime contractor liable for a 2% per month penalty if the prime contractor is paid for the subcontractor's work but the prime contractor fails to pay the subcontractor. Section 7108.5 also allows CSLB to take disciplinary action on the same grounds as the penalty is provided, but, as revised herein, clarifies that the 2% is awarded in civil court only.

Proposed B&P section 7108.6 would provide the same protections for material suppliers and equipment renters. The new material supplier section tracks the existing subcontractor section which allows the contractor to withhold payment based on a good faith dispute.

Proposed Text

7108.6. Unless otherwise agreed to in writing, a prime contractor (or subcontractor) shall pay to any material supplier or equipment renter, not later than 10 days of receipt of each payment received by the contractor and designated for that purpose, the respective amounts allowed the contractor on account of the materials supplied or service provided by the material supplier or equipment renter, to the extent of each material supplier or equipment renter's interest therein. In the event that there is a good faith dispute over all or any portion of the amount due on a progress payment from the prime contractor or subcontractor to a subcontractor, then the prime contractor or subcontractor may withhold no more than 150 percent of the disputed amount. Any violation of this section as found in civil court shall subject the licensee to a penalty payable to the material supplier or equipment renter of 2 percent of the amount due per month for every month that payment is not made. In any action for the collection of funds wrongfully withheld, the prevailing party shall be entitled to his or her attorney's fees and costs.

Any violation of this section shall constitute a cause for disciplinary action.

The sanctions authorized under this section shall be separate from, and in addition to, all other remedies either civil, administrative, or criminal.

This section applies to all private works of improvement and to all public works of improvement, except where Section 10262 of the Public Contract Code applies.

Revision Considerations: 1.Need revision so that the payment owed must have come due and the consumer has paid before the penalty kicks in. 2. Policy choice: 2% at court only or awarded through CSLB as well?

New Remedy

Consequential Damages Remedy: Mandate General Liability Insurance.

Under present CSLB law, general liability insurance (GLI) is not required. In the first 6 months of this year, CSLB held two workshops examining the value and availability of GLI.

The workshops demonstrated:

- GLI would close a gap in CSLB's consumer protection strategies by creating a readily available remedy for homeowners.
- The present consumer protection mechanisms of CSLB disciplinary action and the contractor's bond are not aimed at the same kind of injury as is GLI.
- GLI is carried by contractors to protect their own assets. When a contractor fails to carry GLI, it may means that he or she does not have enough assets to cause the contractor to fear a lawsuit.
- When the contractor has neither assets nor GLI, the homeowner unknowingly carries all the risk of contractor caused damage.
- A homeowner who carries homeowners' insurance can shift some of that risk onto his or her homeowner's insurance. The homeowner is still subject, however, to policy deductibles and runs the additional risk of increased rates or outright cancellation.
- Most public contracts and most commercial contracts require a contractor to carry GLI.
- GLI is surprisingly available across the board. However, there is still a portion of licensed contractors who will be unable to qualify for GLI - a pool or pool substitute may be needed.

Discussion

CSLB's first workshop identified the value of GLI. When "consequential" or "secondary" damage is caused in a consumer's home by contractor misconduct or misadventure, unless the contractor carries general liability insurance, the home owner is usually left to sue the contractor in civil court or rely on the homeowner's own homeowner's insurance. Where there is a significant payment by the insurance company, the homeowner risks raised premiums or outright cancellation.

A number of contractors working in the home improvement arena have chosen to carry GLI. These contractors generally carry the insurance to protect themselves from a suit by an irate customer. The contractor who chooses not to carry GLI often makes this choice because he or she lacks sufficient assets to need protection. The contractor who lacks sufficient assets to attach in a civil suit is usually also the contractor who does not carry insurance.

CSLB's second workshop examined the availability of GLI across the board. Although some workshop participants were surprised that GLI is easy to obtain, most participants agreed that there would be a small but significant portion of licensed contractors who would be unable to obtain this insurance and a pool would be required.

Since the acknowledgment that, prior to mandating GLI, a pool or pool substitute would have to be provided, none of the supporters of mandatory GLI have come forward with a plan for a pool. It is unclear at present whether this proposal will be implemented.

Assemblywoman Susan Davis' bill (AB 1288) would mandate that all contractors carry GLI. The Board has taken a watch position on this issue.

Improve Consumer Information/Disclosure
Mechanic's Lien Warning

The proposed revision:

- Creates a more user friendly Notice to Owner
    - Explains danger of mechanic's liens
    - Describes some limitations of the licensing bond
    - Describes methods of avoiding mechanic's liens
- Requires written receipt of notice for work of $500 or more
- Provides for an interim version until CSLB can proceed with a regulation based on industry and consumer input.

Note: Surety Company of the Pacific is sponsoring this legislation.

Text

The Legislature finds and declares that mechanic's liens resulting from a failure of a licensed contractor to pay his or her obligations to subcontractors, material suppliers, laborers, and other individuals contributing to a work of home improvement, including repairing, remodeling and adding to a residence, or contributing to swimming pool construction are a significant problem in the state of California. The legislature recognizes that one way to assist homeowners to avoid these liens is to provide homeowners with information about mechanic's liens prior to the homeowner entering into a contract for home improvement with a licensed contractor. The purpose of this information is to warn the homeowner about mechanic's liens and ways to avoid them.

The Legislature also recognizes that this kind of notice is best created and maintained through a regulatory process which enables the Contractor's State License Board, industry and consumers to join together to create usable warnings. Therefore, the Legislature instructs the Contractor's State License Board to consult with representatives of the construction industry, with consumer groups and with other parties which have demonstrated an interest in the issue of mechanic's liens and, as soon as is practicable, to develop and promulgate administrative regulation or regulations designed as a

warning to homeowners concerning mechanic's liens and ways to avoid them and to create a new warning. Upon adoption of the regulations creating a new "Mechanic's Lien Warning," the interim warning will become inoperative.

Mechanic's Lien Warning

7018.5. (a) The board shall, by regulation, prescribe a form entitled "Mechanic's Lien Warning." ~~"Notice to Owner" which shall state:~~

~~"Under the California Mechanics' Lien Law, any contractor, subcontractor, laborer, supplier, or other person or entity who helps to improve your property, but is not paid for his or her work or supplies, has a right to place a lien on your home, land, or property where the work was performed and to sue you in court to obtain payment.~~

~~This means that after a court hearing, your home, land, and property could be sold by a court officer and the proceeds of the sale used to satisfy what you owe. This can happen even if you have paid your contractor in full if the contractor's subcontractors, laborers, or suppliers remain unpaid.~~

~~To preserve their rights to file a claim or lien against your property, certain claimants such as subcontractors or material suppliers are each required to provide you with a document called a "Preliminary Notice." Contractors and laborers who contract with owners directly do not have to provide such notice since you are aware of their existence as an owner. A preliminary notice is not a lien against your property. Its purpose is to notify you of persons or entities that may have a right to file a lien against your property if they are not paid. In order to perfect their lien rights, a contractor, subcontractor, supplier, or laborer must file a mechanics' lien with the county recorder which then becomes a recorded lien against your property. Generally, the maximum time allowed for filing a mechanics' lien against your property is 90 days after substantial completion of your project.~~

~~TO INSURE EXTRA PROTECTION FOR YOURSELF AND YOUR PROPERTY, YOU MAY WISH TO TAKE ONE OR MORE OF THE FOLLOWING STEPS:~~

~~(1) Require that your contractor supply you with a payment and performance bond (not a license bond), which provides that the bonding company will either complete the project or pay damages up to the amount of the bond. This payment and performance bond as well as a copy of the construction contract should be filed with the county recorder for your further protection. The payment and performance bond will usually cost from 1 to 5 percent of the~~

~~contract amount depending on the contractor's bonding ability. If a contractor cannot obtain such bonding, it may indicate his or her financial incapacity.~~

~~—(2) Require that payments be made directly to subcontractors and material suppliers through a joint control. Funding services may be available, for a fee, in your area which will establish voucher or other means of payment to your contractor. These services may also provide you with lien waivers and other forms of protection. Any joint control agreement should include the addendum approved by the registrar.~~

~~—(3) Issue joint checks for payment, made out to both your contractor and subcontractors or material suppliers involved in the project. The joint checks should be made payable to the persons or entities which send preliminary notices to you. Those persons or entities have indicated that they may have lien rights on your property, therefore you need to protect yourself. This will help to insure that all persons due payment are actually paid.~~

~~—(4) Upon making payment on any completed phase of the project, and before making any further payments, require your contractor to provide you with unconditional "Waiver and Release" forms signed by each material supplier, subcontractor, and laborer involved in that portion of the work for which payment was made. The statutory lien releases are set forth in exact language in Section 3262 of the Civil Code. Most stationery stores will sell the "Waiver and Release" forms if your contractor does not have them. The material suppliers, subcontractors, and laborers that you obtain releases from are those persons or entities who have filed preliminary notices with you. If you are not certain of the material suppliers, subcontractors, and laborers working on your project, you may obtain a list from your contractor. On projects involving improvements to a single-family residence or a duplex owned by individuals, the persons signing these releases lose the right to file a mechanics' lien claim against your property. In other types of construction, this protection may still be important, but may not be as complete.~~

~~—To protect yourself under this option, you must be certain that all material suppliers, subcontractors, and laborers have signed the "Waiver and Release" form. If a mechanics' lien has been filed against your property, it can only be voluntarily released by a recorded "Release of Mechanics' Lien" signed by the person or entity that filed the mechanics' lien against your property unless the lawsuit to enforce the lien was not timely filed. You should not make any final payments until any and all such liens are removed. You should consult an attorney if a lien is filed against your property."~~

Until the board adopts a regulation describing mechanic's liens and ways to avoid them, the following notice, with headings in 16 point type, and text in 12 point type with emphasis as written, shall be used.

Mechanic's Lien Warning:

To Avoid Liens on Your Home
Please Read This Warning Carefully

You probably realize that, if you don't pay your contractor, the contractor has a right to place a mechanic's lien on the home, land, or property where the work was performed, and the contractor may sue you in court to obtain payment. This means that, after a court hearing your home, land, and property could be sold by a court officer and the proceeds of the sale used to satisfy what you owe.

You may not realize, however, that subcontractors, laborers, material suppliers and other persons or entities that contribute to your home improvement project also can place a lien on your home, land, or property. **This can happen even if you have paid your contractor in full.** Each year, many California homeowners pay twice for the same work because the contractor fails to pay the subcontractors, laborers and material suppliers. **You may even lose your home.**

HOW TO PROTECT YOURSELF

Inform yourself about liens and ways to prevent them. The Contractors State License Board (CSLB) can provide you with a pamphlet describing liens and how they work. You can get a copy of the pamphlet, "Mechanic's Liens," by calling the CSLB information number 800-255-xxxx or through the CSLB website (www.cslb.ca.gov).

Watch for Preliminary Notices. Subcontractors, material suppliers, and some other claimants are required to provide you with a document called a "Preliminary Notice" if they want to preserve their rights to file a lien against your property. The Preliminary Notice notifies you of a claim against your property that may result in a mechanic's lien if the claim is not paid. Be aware that on jobs completed quickly, the Preliminary Notice may not be sent until after the job is complete. See the discussion of waiver and release below.

Obtain a list of possible claimants. If you don't know whether the contractor has arranged for subcontractors, laborers, and material suppliers to provide material or services to your project, ask your contractor for a list. You may want to match this list with the scheduled payments described in the contract to determine when payment is due to each person contributing to your work of home improvement. See the discussion of waiver and release below.

Understand that license bonds have limitations. Your contractor must post some form of financial security with CSLB, usually a contractor's license bond. The amount of this license bond is usually only $7,500 ($10,000 for a swimming pool contractor). This amount may be the only financial security available to cover damages caused by a contractor's violation of the contractors' license law. A contractor who does not pay the subcontractors, laborers and material suppliers for your job may also fail to fulfill his or her obligations to other customers. Consequently, the bond amount may not be enough to pay all or even a part of your claim.

Ways to make sure that those who could claim lien rights are paid include:

1. **Hire a joint control service.** Joint control companies, licensed by the Department of Corporations, are available throughout the state. Under this plan, you pay the joint control company and the joint control company pays the contractor, subcontractor, material supplier etc. Make sure that any joint control agreement includes CSLB approved procedures.

2. **Issue joint checks.** Under the joint check plan, you issue checks for payments made out to **both** the contractor and the subcontractor (s) or material supplier(s) involved in the project. This will help to ensure, although it does not guarantee, that all persons due payment are actually paid.

3. **Require payment and performance bonds** (not a license bond). Under this plan, the contractor purchases payment and performance bonds. These bonds require the issuing company to complete the project and/or pay damages up to the amount of the bond. The contractor may pass the cost of this bond on to you, the homeowner.

Get an Unconditional Waiver and Release. No matter what method you use to make sure payment is made, you should always get a **signed** "Unconditional Waiver and Release" from each possible claimant. Bear in mind, an unconditional release signed by the

contractor does not cover the work of anyone else who contributed to the project. **Each unconditional release covers only the subcontractor, material supplier or laborer who signs it and covers only the portion of work for which payment is made.** The exact language of a lien release is set forth in Section 3262 of the Civil Code. Most stationery stores will sell the "Waiver and Release" forms if your contractor does not have them. Beware: conditional releases do not release a claimant's right file a lien once they have been paid.

(b) ~~Each contractor licensed under this chapter,~~ Prior to entering into a contract with an owner for more than $500 of work specified as home improvement or swimming pool construction pursuant to Section 7159, the contractor shall give a copy of ~~"Notice to Owner"~~ the "Mechanic's Lien Warning" described in section (a) to the owner, the owner's agent, or the payer, and shall obtain from that person a written receipt which states that the person has received and read the warning. The contractor is required to treat the copy of the "Mechanic's Lien Warning" as a written record pursuant to Section 7111. The failure to provide this notice as required shall constitute grounds for disciplinary action.

Improved Consumer Information/Disclosure
The 5 Day Preliminary Notice

- Preliminary 20-Day Notice triggers lien rights by providing lien notices up to 20 days *after* the work has started
- New Notice would be sent 5 days prior to the start of work or personally served before the subcontractor or material supplier provides any material or services
- New Notice would be required for single family residences only; otherwise, 20-Day Notice is sufficient
- New Notice is user friendly and should echo the information given to the homeowner by the contractor in the Mechanic's Lien Warning.

Discussion

The present Preliminary 20-Day Notice has been demonstrated to be ineffective for some homeowners for two reasons. First, the name of the notice is misleading. The notice is not preliminary to the creation of an obligation that may result in a lien. It is preliminary only to the actual lien filing. Thus, right now the notice can be legally served *after* the work is done. This is a problem for homeowners who pay the contractor before receiving the notice.

The second problem is that the Notice is not as explicit as it could be in warning homeowners of the lien problem. The proposed new "Preliminary Notice to Homeowner Notice" is more consumer friendly.

Proposed New Civil Code Section

Civil Code 3097.2 Subcontractors, laborers, material suppliers, or other persons or entities, including certificated architects, registered engineers, or licensed land surveyors, seeking to assert mechanics lien rights on home improvement projects involving a single-family residence or a duplex owned by resident individuals must provide a "Preliminary Notice to Homeowner" to the owner or reputed owner, to the original contractor, or reputed contractor, and to the construction lender, if any, or to the reputed construction lender, if

any, a written homeowner's notice as prescribed by this section. This notice is effective 5 days after it is given. The notice can be made effective immediately if delivered personally to the person to whom notice is to be given. No mechanic's lien rights accrue prior to the effective date.

(e) "Preliminary Notice to Homeowner" means a written notice from subcontractors, laborers, material suppliers, or other persons or entities seeking to assert mechanics lien rights on home improvement contracts involving a single-family residence or a duplex owned by individuals. This notice may be considered a Preliminary 20-day Notice if it also meets all the requirements set forth in section 3097.

(f) The "Preliminary Notice to Homeowner" shall contain the following information:

(1) A notice describing the dangers of mechanic's liens as follows:

Each year a number of California homeowners lose their homes because the contractor fails to pay the subcontractors, material suppliers, equipment renters and/or laborers who contributed to the home improvement project.

Persons or entities that contribute to your home improvement project can place a lien on the home, land, or property that was improved and, if they are not paid, can sue you in court to obtain payment. After a court hearing, a court officer can sell your home, land, and property and use the proceeds of the sale used to satisfy the lienholder's demands for payment. **This can happen even if you have paid your contractor in full.**

To determine ways to protect yourself, you may wish to review the "Mechanic's Lien Warning" appearing below. Contractors License Law requires your contractor given to you by your contractor when you signed the home improvement contract. A contractor's failure to provide you with this warning is a serious violation of Contractor's License Law. You may wish to contact the Contractors State License Board for more information on liens and how to prevent them by calling 916-255-XXX or at CSLB's website at www.cslb.ca.gov.

(2) A general description of the labor, service, equipment, or materials to be furnished.

(3) The name and address of the person furnishing that labor, service, equipment, or materials.
(4) The name of the person who contracted for purchase of that labor, service, equipment, or materials.
(5) A description of the jobsite sufficient for identification.
(6) A copy of the Mechanic's Lien Warning duplicating the notice provided by the contractor before entering into a contract.

(d) The notice required under this section may be served as follows:

(1) If the person to be notified resides in this state, by delivering the notice personally, or by leaving it at his or her address of residence or place of business with some person in charge, or by first-class registered or certified mail, postage prepaid, addressed to the person to whom notice is to be given at his or her residence or place of business address or at the address shown by the building permit on file with the authority issuing a building permit for the work, or at an address recorded pursuant to section 3097 (j).

(2) If the person to be notified does not reside in this state, by any method enumerated in paragraph (1) of this subdivision. If the person cannot be served by any of these methods, then notice may be given by first-class certified or registered mail, addressed to the construction lender or to the original contractor.

(3) When service is made by first-class certified or registered mail, service is complete at the time of the deposit of that registered or certified mail.

Revision Points: 1. Consider this notice to be in addition to the PN notice and to be effective only when the harm the notice is designed to prevent (contractor paid and gone before the homeowner knows of lien right) actually occurs. If contractor is not paid before notice is given and 20 day PN is actually adequate, the new notice is moot.

Improve Consumer Information/Disclosure

Legislation Addressing Contractor's Failure to Provide a Notice (Proposed New B&P Section 7159.3)

- Provide more stringent enforcement of notice requirements by specifying that where a notice was required but not given and the harm the notice was designed to prevent occurs, the harm will be presumed to have been intentional

- Provide better consumer information by making sure required notices are appropriately given and displayed.

Discussion

Under present licensing law, the contractor is required to give the consumer a number of notices. For example, the contractor is required to present a consumer with a Notice to Owner (a new version is provided herein) designed to provide the consumer with information about liens. There are three or four other notices also required. Each statute requiring a notice also provides that failure to provide the notice constitutes grounds for discipline. This code section goes further. It ties the lack of notice to the harm the notice was designed to prevent and concludes that, where both occur, the harm must have been intentional.

This proposal also would prohibit burying required notices and information in unreadable contracts.

Proposed Text

7159.3 (a)Where the legislature requires that a notice or warning be given, and that notice or warning is not given and the harm the notice or warning was designed to prevent occurs, the licensee will be presumed to have acted intentionally.

(b) If the contract is written so as to obscure the notices or warnings or other information the legislature has determined must be provided to the consumer, and the harm the notice, warning or other information was designed to prevent or mitigate occurs, the licensee will be presumed to have acted intentionally.

Improved Consumer Information/Disclosure

Revision of Home Improvement Notice Statute (B&P Code 7159)

- Splits present 7159 into two code sections. One section includes required notices. The other section presents the substantive provisions to which the notices pertain.

- The split would:

  - clarify the notice

  - distinguish the penalties for a notice violation from a substantive violation

  - establish a more severe punishment for situations where the lack of the required notice contributes to a fraudulent plan.

- The proposed amendment also would:

  - create a penalty to apply when a violation of the notice requirements can be identified as a cause for a financial injury. For example, the contract failed to notify the homeowner that a subcontractor was hired. The homeowner paid the contractor but the contractor failed to pay the sub and the sub placed a lien on the home.

  - add a requirement that the contractor inform the consumer of all subs and material suppliers who are accruing lien rights.

  - may cover some of the same ground as the previous notice related legislation.

Splits 7159 into two sections.* Section 7159 includes the notice requirements and provides criminal and civil penalties for failure to comply. The contracting requirements removed from 7159 are moved to 7159.1. Draft includes some new provisions including notice that contractor may not collect more than amount provided by law, general liability status, etc.

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*Revises section 7159 to segregate the notice requirements from the substantive prohibitions. For clarity of reading, two sets of changes were made to the code section. First 7159 was amended to apply only to notice provisions. Second, it was amended as 7159.1 to include only the substantive provisions.

7159. This section applies only to home improvement contracts, as defined in Section 7151.2, between a contractor, whether a general contractor or a specialty contractor, who is licensed or subject to be licensed pursuant to this chapter with regard to the transaction and who contracts with an owner or tenant for work upon a residential building or structure, or upon land adjacent thereto, for proposed repairing, remodeling, altering, converting, modernizing, or adding to the residential building or structure or land adjacent thereto, and where the aggregate contract price specified in one or more improvement contracts, including all labor, services, and materials to be furnished by the contractor, exceeds five hundred dollars ($500).

Every home improvement contract and every contract, the primary purpose of which is the construction of a swimming pool, is subject to the notice requirements in this section. Every contract and any changes in the contract subject to this section shall be evidenced by a writing and shall be signed by all the parties to the contract. The writing shall contain at least the following information in at least 10 point type:
~~all of the following~~:

(a) The statement:

A Message from the Contractors State License Board

The home improvement contract is the agreement between you, the person contracting for a home improvement or swimming pool project and the contractor. The contract is used to make sure that contractors and consumers agree on the work to be performed: how it will be done, when it will be done, what materials will be used, how much it will cost, and whether subcontractors, material suppliers or equipment renters contributing to your project have mechanic's lien rights. If your contract doesn't answer these questions, you may not be sufficiently protected in a later dispute.

For more information on home improvement contracting, call the Contractors State License Board at , or contact our website at .

~~(a)~~ (b) The name, address, and license number of the contractor, and, if applicable, the name and registration number of any salesperson who solicited or negotiated the contract.

~~(b)~~ (c)A statement indicating whether the contractor carries minimum general liability insurance. The minimum to be defined by the board in regulation.

~~(b)~~ (d)The approximate dates when the work will begin and on which all construction is to be completed.

~~(c)~~ (e)A plan and scale drawing showing the shape, size, dimensions, and construction and equipment specifications for a swimming pool and for other home improvements, a description of the work to be done and description of the materials to be used and the equipment to be used or installed, and the agreed consideration for the work.

~~(d)~~ (f) ~~If the payment schedule contained in the contract provides for a~~ The amount of the downpayment to be paid to the contractor by the owner or the tenant before the commencement of work, and a statement indicating that the downpayment may not exceed two hundred dollars ($200) or 2 percent of the contract price for swimming pools, or one thousand dollars ($1,000) or 10 percent of the contract price for other home improvements, excluding finance charges, whichever is less.

~~(e)~~ (g) A schedule of payments showing the amount of each payment as a sum in dollars and cents. ~~In no event may the payment schedule provide for the contractor to receive, nor may the contractor actually receive, payments in excess of 100 percent of the value of the work performed on the project at any time, excluding finance charges, except that the contractor may receive an initial downpayment authorized by subdivision (d). With respect to a swimming pool contract, the final payment may be made at the completion of the final plastering phase of construction, provided that any installation or construction of equipment, decking, or fencing required by the contract is also completed.~~ A statement that the ~~A~~ failure by the contractor ~~without lawful excuse~~ to substantially commence work within 20 days of the approximate date specified in the contract ~~when work will begin shall~~ postpones the next succeeding payment ~~to the contractor~~ for a ~~that~~ period of time equivalent to the delay in commencement. ~~time between when substantial commencement was to have occurred and when it did occur.~~ A statement that failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of the Contractors' State License Law. The schedule of payments shall be stated in dollars and cents, and shall be specifically referenced to the amount of work or services to be performed and to any materials and equipment to be supplied. ~~With respect to a contract that provides for a schedule of monthly payments to be made by the owner or tenant and for a schedule of payments to be disbursed to the contractor by a person or entity to whom the contractor intends to assign the right to receive the owner's or tenant's monthly payments, the payments referred to in this subdivision mean the payments to be disbursed by the assignee and not those payments to be made by the owner or tenant.~~ The contract shall also include the statement that "Any request for payment made pursuant to the schedule of payments must include a list of the subcontractors, material suppliers, and equipment renters contributing to the work or services

performed and/or materials and equipment supplied relevant to that progress payment."

~~(f)~~ (h) A statement that, upon satisfactory payment being made for any portion of the work performed, the contractor shall, prior to any further payment being made, furnish to the person contracting for the home improvement or swimming pool with a full and unconditional release from any claim or mechanic's lien ~~pursuant to Section 3114 of the Civil Code~~ for that portion of the work for which payment has been made. In addition, the contract shall include the statement that "A full and unconditional release of a claim or lien by the contractor does not release the claims or liens of a subcontractor or other person or entity contributing to the project. You should make certain that unconditional releases are provided from all persons or entities contributing to the project.

~~(g)~~ (i) ~~The requirements set forth in subdivisions (d), (e), and (f) do not apply when the contract provides for the contractor to furnish a performance and payment bond, lien and completion bond, bond equivalent, or joint control approved by the registrar covering full performance and completion of the contract and the bonds or joint control is or are furnished by the contractor, or when the parties agree for full payment to be made upon or for a schedule of payments to commence after satisfactory completion of the project.~~ The contract shall contain, in close proximity to the signatures of the owner and contractor, a notice in at least 10-point type stating that the owner or tenant has the right to require the contractor to have a performance and payment bond.

~~(h)~~ (j) A statement indicating that, to be enforceable, agreements for extra or change order work must be made in writing and signed by all parties to the contract but failure to comply with the writing requirement does not, by itself, ~~No extra or change-order work may be required to be performed without prior written authorization of therson contracting for the construction of the home improvement or swimming pool. No change-order is enforceable against the person contracting for home improvement work or swimming pool construction unless it clearly sets forth the scope of work encompassed by the change-order and the price to be charged for the changes. Any change-order forms for changes or extra work shall be incorporated in, and become a part of, the contract. Failure to comply with the requirements of this subdivision does not~~ preclude the recovery of compensation for work performed based upon quasi-contract, quantum meruit, restitution, or other similar legal or equitable remedies designed to prevent unjust enrichment.

~~(i))If the contract provides for a payment of a salesperson's commission out of the contract price that payment shall be made on a pro rata basis in proportion to the schedule of payments made to the contractor by the disbursing party in accordance with subdivision~~

~~(c).~~

~~(j)~~ (k)The language of the notice required pursuant to Section 7018.5.

~~(k)~~ (l) What constitutes substantial commencement of work pursuant to the contract.

~~(k)~~ (m)~~A notice that failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of the Contractors' State License Law.~~

~~(m)~~ (n) ~~If the contract provides for a contractor to furnish joint control, the contractor shall not have any financial or other interest in the joint control.~~

~~A failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of this section.~~

~~This section does not prohibit the parties to a home improvement contract from agreeing to a contract or account subject to Chapter 1 (commencing with Section 1801) of Title 2 of Part 4 of Division 3 of the Civil Code.~~

The writing may also contain other matters agreed to by the parties to the contract. The writing shall be legible and shall be in a form that clearly describes any other document that is to be incorporated into the contract. Before any work is done, the owner shall be furnished a copy of the written agreement, signed by the contractor.

~~For purposes of this section, the board shall, by regulation, determine what constitutes "without lawful excuse."~~

~~The provisions of this section are not exclusive and do not relieve the contractor or any contract subject to it from compliance with all other applicable provisions of law.~~

(p) A violation of the notice provisions of this section by a licensee, or a person subject to be licensed, under this chapter, or by his or her agent or salesperson, is a misdemeanor punishable by a fine of not less than one hundred dollars ($100) nor more than five thousand dollars ($5,000), or by imprisonment in the county jail not exceeding one year, or by both that fine and imprisonment.

(q) Any person who violates the notice provisions of this section as part of a plan or scheme to defraud an owner of a residential or nonresidential structure, including a mobilehome or manufactured home, in connection with the offer or performance of repairs to the structure for damage caused by a natural disaster, shall be ordered by the court to make full restitution to the victim based on the person's ability to pay, as defined in subdivision (e) of Section 1203.1b of the Penal Code. In addition to full restitution, and imprisonment authorized by this section, the court may impose a fine of not less than five hundred dollars ($500) nor more than twenty-five thousand dollars

($25,000), based upon the defendant's ability to pay. This subdivision applies to natural disasters for which a state of emergency is proclaimed by the Governor pursuant to Section 8625 of the Government Code or for which an emergency or major disaster is declared by the President of the United States.

(r) The court may impose a fine of not less than $500 nor more than twenty-five thousand dollars ($10,000), based upon the defendant's ability to pay, upon a person who violates the notice provisions of this section as part of a plan or scheme to defraud an owner of a residential or nonresidential structure, including a mobilehome or manufactured home, in connection with a home improvement or swimming pool project.

7159. 1 This section applies only to home improvement contracts, as defined in Section 7151.2, between a contractor, whether a general contractor or a specialty contractor, who is licensed or subject to be licensed pursuant to this chapter with regard to the transaction and who contracts with an owner or tenant for work upon a residential building or structure, or upon land adjacent thereto, for proposed repairing, remodeling, altering, converting, modernizing, or adding to the residential building or structure or land adjacent thereto, and where the aggregate contract price specified in one or more improvement contracts, including all labor, services, and materials to be furnished by the contractor, exceeds five hundred dollars ($500).

Every home improvement contract and every contract, the primary purpose of which is the construction of a swimming pool, is subject to this section.

~~(d)~~ (a) If the payment schedule contained in the contract provides for a downpayment to be paid to the contractor by the owner or the tenant before the commencement of work, the downpayment may not exceed two hundred dollars ($200) or 2 percent of the contract price for swimming pools, or one thousand dollars ($1,000) or 10 percent of the contract price for other home improvements, excluding finance charges, whichever is less.

~~(e)~~ (b) In no event may the payment schedule provide for the contractor to receive, nor may the contractor actually receive, payments in excess of 100 percent of the value of the work performed on the project at any time, excluding finance charges, except that the contractor may receive an initial downpayment authorized by subdivision (d). With respect to a swimming pool contract, the final payment may be made at the completion of the final plastering phase of construction, provided that any installation or construction of equipment, decking, or fencing required by the contract is also completed. A failure by the contractor ~~without lawful excuse~~ to

substantially commence work within 20 days of the approximate date specified in the contract when work will begin shall postpone the next succeeding payment to the contractor for that period of time equivalent to the time between when substantial commencement was to have occurred and when it did occur. With respect to a contract that provides for a schedule of monthly payments to be made by the owner or tenant and for a schedule of payments to be disbursed to the contractor by a person or entity to whom the contractor intends to assign the right to receive the owner's or tenant's monthly payments, the payments referred to in this subdivision mean the payments to be disbursed by the assignee and not those payments to be made by the owner or tenant.

~~(f)~~ (c) Any demand for payment made pursuant to the schedule of payments must include a list of the subcontractors, material suppliers, and equipment renters contributing to the work or services performed and/or materials and equipment supplied. Upon satisfactory payment being made for any portion of the work performed, the contractor shall, prior to any further payment being made, furnish to the person contracting for the home improvement or swimming pool a full and unconditional release from any claim or mechanic's lien pursuant to Section 3114 of the Civil Code for that portion of the work for which payment has been made. Notwithstanding the contractor's furnishing of a full and unconditional release, the person contracting for a home improvement project or swimming pool has the right to withhold progress payments to the contractor until the person contracting has been provided with satisfactory evidence that all payments have been timely made to potential lien claimants.

~~(g)~~ (d) The requirements set forth in subdivisions ~~(d), (e), and (f)~~ (a), (b), and (c) do not apply when the contract provides for the contractor to furnish a performance and payment bond, lien and completion bond, bond equivalent, or joint control agreement approved by the registrar covering full performance and completion of the contract and the bonds or joint control is or are furnished by the contractor, or when the parties agree for full payment to be made upon or for a schedule of payments to commence after satisfactory completion of the project. ~~The contract shall contain, in close proximity to the signatures of the owner and contractor, a notice in at least 10-point type stating that the owner or tenant has the right to require the contractor to have a performance and payment bond.~~

~~(h)~~ (e) No extra or change-order work may be required to be performed without prior written authorization of the person contracting for the construction of the home improvement or swimming pool. No change-order is enforceable against the person contracting for home improvement work or swimming pool construction unless it clearly sets forth the scope of work encompassed by the change-order and the price to be charged for the changes. Any change-order forms for changes or

extra work shall be incorporated in, and become a part of, the contract. Failure to comply with the requirements of this subdivision does not preclude the recovery of compensation for work performed based upon quasi-contract, quantum meruit, restitution, or other similar legal or equitable remedies designed to prevent unjust enrichment.

~~(i)~~(f) If the contract provides for a payment of a salesperson's commission out of the contract price, that payment shall be made on a pro rata basis in proportion to the schedule of payments made to the contractor by the disbursing party in accordance with subdivision (e).

~~(j)~~ (g) A failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of this section. ~~A notice that failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of the Contractors' State License Law.~~

~~(m)~~ (h)If the contract provides for a contractor to furnish joint control, the contractor shall not have any financial or other interest in the joint control.

~~A failure by the contractor without lawful excuse to substantially commence work within 20 days from the approximate date specified in the contract when work will begin is a violation of this section.~~

This section does not prohibit the parties to a home improvement contract from agreeing to a contract or account subject to Chapter 1 (commencing with Section 1801) of Title 2 of Part 4 of Division 3 of the Civil Code.

~~The writing may also contain other matters agreed to by the parties to the contract.~~

~~The writing shall be legible and shall be in a form that clearly describes any other document that is to be incorporated into the contract. Before any work is done, the owner shall be furnished a copy of the written agreement, signed by the contractor.~~

~~For purposes of this section, the board shall, by regulation, determine what constitutes "without lawful excuse."~~

The provisions of this section are not exclusive and do not relieve the contractor or any contract subject to it from compliance with all other applicable provisions of law.

(i) In addition to constituting a violation of section 7115, ~~A~~ a violation of this section by a licensee, or a person subject to be licensed, under this chapter, or by his or her agent or salesperson, is a misdemeanor punishable by a fine of not less than one hundred dollars ($100) nor more than five thousand dollars ($5,000), or by imprisonment in the county jail not exceeding one year, or by both that fine and imprisonment.

~~(n)~~(j) Any person who violates this section as part of a plan or

scheme to defraud an owner of a residential or nonresidential structure, including a mobilehome or manufactured home, in connection with the offer or performance of repairs to the structure for damage caused by a natural disaster, shall be ordered by the court to make full restitution to the victim based on the person's ability to pay, as defined in subdivision (e) of Section 1203.1b of the Penal Code.

In addition to full restitution, and imprisonment authorized by this section, the court may impose a fine of not less than five hundred dollars ($500) nor more than twenty-five thousand dollars ($25,000), based upon the defendant's ability to pay. This subdivision applies to natural disasters for which a state of emergency is proclaimed by the Governor pursuant to Section 8625 of the Government Code or for which an emergency or major disaster is declared by the President of the United States.

Improved Consumer Information/Disclosure

Mandating Disclosure of General Liability Insurance Status

An alternative to mandatory GLI would be to require contractors to disclose information on GLI. Although consumer notices are often disregarded, in some cases these notices are the only way CSLB can get its message out.

Proposal

- Place information on our website indicating the value of General Liability Insurance to a homeowner contracting for home improvement work.
- Allow contractors who carry GLI to say so on CSLB's website. (This would be policed by requiring participating contractors to name CSLB as an entity to be notified, electronically if cancellation occurs.)
- Require contractors to provide GLI status on the top of each home improvement contract.

No Text. Concept only.

Enhanced Consumer Protection through Criminal Conviction Review - Follow-up from July Meeting

Criminal Conviction Regulations

Introduction

Proposed Regulations

The Board appears ready to go ahead with two regulations. The first clarifies the substantial relationship test used to decide whether a criminal conviction or bad act is substantially related to the qualifications, functions or duties of a licensee. The second clarifies rehabilitation.

Regulation on renewals held until fingerprints approved

Also included here is a regulation that would be used to determine when to take action based on information about a criminal conviction that was disclosed in the *renewal* process. This proposed regulation is provided as a means of thinking through how the renewal piece would work. Although it is our understanding that right now we have the authority to use the renewal process to request information about criminal convictions, we are not going forward at this time. It did not make sense to take action against those licensees who tell the truth when we had no way to identify licensees who failed to tell the truth.

Regulations

Proposed Revision of Rule §868

After re-examining Rule §868, and its emphasis on construction related examples, staff decided to propose more relevant examples.

Proposed Rule §868 criteria applies equally to applications for licensure and for actions taken under the disciplinary process to suspend or revoke a license.

The proposed amended language would:

- improve notice to staff, applicants and licensees on the meaning of "substantially related" by providing more relevant examples.
- although we are not limited to these examples, the proposal focuses on construction related criminal acts that involve dishonesty and felonies.
- allow staff to pass without review applicants with single DUIs or simple drug possession.

Proposed Text :
Rule §868. Criteria to Aid in Determining if Acts or Crimes Are Substantially Related to Contracting Business.

For the purposes of denial, suspension, or revocation of a license or home improvement salesperson's registration ~~pursuant to Division 1.5 (commencing with Section 475) of the code~~, a crime or act shall be considered to be substantially related to the qualifications, functions or duties of a contractor licensee or home improvement salesperson (under Division 3, Chapter 9 of the code), if to a substantial degree, it evidences present or potential unfitness of a contractor licensee or home improvement salesperson to perform the functions authorized by the license or registration in a manner consistent with the public health, safety, or welfare. The crimes or acts shall include, but not be limited to the following:

(a) Any violation of the provisions of Chapter 9 of Division 3 of the code.

~~(b) Submitting false vouchers to obtain construction loan funds and not using the funds for purpose for which the claim was submitted.~~

~~(c) Willfully rebating to or on behalf of anyone contracting~~

~~with a licensee, any part of money tendered the licensee for the provision of services, labor, materials or equipment.~~

~~(d) Theft of building materials or equipment for use on a construction project.~~

(b) Any act related to the construction trade or contracting profession that is subject to criminal prosecution.

(c) Any act of fraud, misrepresentation and/or dishonesty that is subject to criminal prosecution.

(d) Any serious crime. A serious crime is any felony.

(e) Failure to comply with the provisions of the California Administrative Code, Chapter 8, Title 16.

All convictions, except minor traffic violations, must be reported. In its review, however, the board will not consider a single conviction of driving under the influence or possession of a controlled substance (for personal use) to be a crime substantially related to the qualifications, functions or duties of a licensee or registrant.

Authority cited: Sections 481 and 7008, Business and Professions Code.
Reference: Sections 480, 481, 7066,
7067 and 7069, Business and Professions Code.

REHABILITATION: Rule 869

Once the substantial relationship test has been made, the second part of the review focuses on whether evidence of rehabilitation indicates the license application should be approved or, for current licensees, the license should be suspended or revoked through the disciplinary process.

After working with the criteria in the present version of Rule 869 to evaluate hundreds of applications disclosing criminal convictions, staff proposes that Rule 869 be revised in two areas:

- to put a limit on the time a conviction can be considered
- to better define "rehabilitation."

Proposed Rule §869 (a) as it applies to applicants:

(a) When considering the denial of a contractor's license or

home improvement ~~salesman's~~ salesperson's registration under Section 480 of the code, the Board, in evaluating the applicant's rehabilitation and present eligibility for a license or registration will consider the following criteria:

(1) The nature and severity of the act(s) or crime(s) under consideration as grounds for denial.

(2) Evidence of any act(s) committed subsequent to the act(s) or crime(s) under consideration as grounds for denial which also could be considered as grounds for denial under Section 480 of the code.

(3) The time ~~that has~~ elapsed since commission of the act(s) or crime(s) referred to in subdivision (1) or (2). If there is no evidence of acts or crime(s) referred to in subdivision (2), the maximum time period within which the board will continue to evaluate a criminal conviction will be 5 years running from the date of release from custody, parole or probation plus 4 years for committing a crime that can carry a life sentence (kidnaping, murder, etc.) or 2 years for other crimes. After the maximum time has elapsed, the applicant will be presumed to have been rehabilitated.

(4) The extent to which the applicant has complied with any terms of parole, probation, restitution, or any other sanctions lawfully imposed against the applicant.

(5) Evidence of a lack of rehabilitation including conviction of crimes not substantially related to the qualifications, functions and duties of a licensee or registrant.

(6) Evidence, if any, of rehabilitation submitted by the applicant including but not limited to:

a) letters from a probation or parole authority;

b) evidence of a solid work history since the time of the conviction or release from custody;

c) any other evidence demonstrating potential or present fitness for licensure.

Proposed Rule 869 (b) as it applies to licensees:
Criteria for Rehabilitation

Proposed Rule 869 (b):

b) When considering the suspension or revocation of a contractor's license or home improvement salesperson's registration on the grounds the licensee or registrant has been convicted of a crime, the Board, in evaluating the licensee's rehabilitation and present eligibility for a license or home improvement salesman's registration will consider the following criteria:

(1) Nature and severity of the act(s) or offense(s).

(2) Evidence of any act(s) committed subsequent to the act(s) or crime(s) under consideration as grounds for denial which also could be considered as grounds for denial under Section 480 of the code including failure to disclose a criminal conviction on the original application or in subsequent renewal applications.

(3) Total criminal record.

(4) The time ~~that has~~ elapsed since commission of the act(s) or offense(s). If there is no evidence of acts or crime(s) referred to in subdivision (2), the maximum time period within which the board will continue to evaluate a criminal conviction will be 5 years running from the date of release from custody, parole or probation plus 4 years for committing a crime that can carry a life sentence (kidnaping, murder, etc.) or 2 years for other crimes. After the maximum time has elapsed, the licensee will be presumed to have been rehabilitated.

(5) The extent to which the licensee or registrant has complied with any terms of parole, probation, restitution, or any other sanctions lawfully imposed against the applicant.

(6) Whether the licensee or registrant has complied with any terms of parole, probation, restitution or any other sanctions lawfully imposed against the licensee.

(7) If applicable, evidence of expungement proceedings pursuant to Section 1203.4 of the Penal Code.

(8) The presumption of rehabilitation as provided in Rule 869.1.

(9) Evidence, if any, of rehabilitation submitted by the

licensee, as described in Rule 869 (5) .

Authority cited: Sections 482 and 7008, Business and Professions Code. Reference: Sections 480, 482, 490 and 7069, Business and Professions Code.

Enhanced Consumer Protection through Criminal Conviction Review
Criminal Convictions Legislative Proposal

Proposed Legislation

The packet also includes new legislative proposals. These proposals are designed to do three things:

- Give the board authority to collect fingerprints from primary applicants for licenses and from primary applicants for renewal.
- require licensees and registrants to report criminal convictions within 30 days.
- specifically authorizes the board to use the renewal process as a means of collecting information about criminal convictions that occurred in the last five years.

Background

Business & Professions Code section 7123 allows the Board to take disciplinary action against a licensed contractor based on criminal convictions substantially related to the qualifications, functions and duties of a contractor. Section 7069 allows the Board to take action against all applicants as well as officers, directors, etc. Yet, CSLB's present system has no structured means of getting criminal conviction information about licensed contractors nor do we have a means of verifying the information we have already gotten from applicants.

Information about the criminal conviction history of licensees can be gathered in four ways:

1. Continue to collect criminal conviction information through the application process for an original license.
2. Create a new law requiring all licensed contractors to report new criminal convictions.
3. Use the renewal process to gather information about criminal convictions of licensees occurring in the past five years which may be subject to review under section 7123.
4. Use DOJ's new fingerprint process to verify the information provided by a targeted segment of the applicant pool.

Legislative Proposals:

Amend Business & Professions Code section 7069 to provide for fingerprinting of all qualifying individuals as well individual owners.

7069. (a) An applicant, including an applicant for a home improvement registration, and each officer, director, partner, associate and responsible managing employee thereof, shall not have committed acts or crimes which are grounds for denial of licensure under Section 480.

(b) As part of the application for a contractor's license or home improvement salesperson's registration, the following categories of individuals shall submit their fingerprints into an electronic fingerprinting system administered by the Department of Justice:

1. a qualifying individual;
2. an individual owner
3. a registrant
4. an individual who reported a criminal conviction in his or her application.

These individuals shall have their fingerprints entered into the system through a terminal operated by a law enforcement agency or other facility authorized by the Department of Justice to conduct electronic fingerprinting. The board may charge the individual a fee to cover the cost of processing the fingerprints. The board, the enforcement agency or other authorized facility may charge the applicant a fee sufficient to reimburse the agency or authorized facility for the costs incurred in collecting the fingerprints.

(b) Upon receipt of the electronic fingerprints as provided in this section, the Department of Justice shall determine whether the individual has been convicted of any crime and forward the information to the board. The Department of Justice's determination will be based on the Department's own data base as well as the Federal Bureau of Investigation's data base.

(c) Once the fingerprints have been entered into the system, the Department of Justice will continue to

monitor the status of each individual to determine if a criminal conviction has occurred. If a criminal conviction is identified, the Department of Justice will forward the information to the board.

Amend B&P 7123 to clarify that salesperson registrations are included and to require all contractors to report past criminal convictions at renewal as well as new criminal convictions.

7123. (a) A conviction of a crime substantially related to the qualifications, functions and duties of a licensed contractor or home improvement salesperson constitutes a cause for disciplinary action. The record of the conviction shall be conclusive evidence thereof.

(b) For a three year period commencing the effective date of the amendment to this section, all applicants applying for renewal of a contractor's license or home improvement salesperson's registration who have incurred a criminal conviction in the past five years, or since they applied for original licensure or registration, whichever is later, shall report to the board all criminal convictions. The board will not review and the applicant need not report crimes exempted by board regulation.

(c) Each contractor licensee and home improvement salesperson is responsible for notifying the Board within 30 days of any new criminal conviction.

Add B&P section 7153.4 to require fingerprints at renewal

(a) As part of the application for renewal of a contractor's license or home improvement salesperson's registration, the following individuals shall submit their fingerprints into an electronic fingerprinting system administered by the Department of Justice:

1. qualifying individuals
2. individual owners
3. registrants
4. individuals who have reported a criminal conviction in the past.

These individuals shall have their fingerprints entered into the system through a terminal operated by a law enforcement agency or other facility authorized by the Department of Justice to conduct electronic fingerprinting.

(b) The board may charge the individual a fee to cover the cost of processing the fingerprints. The board, the enforcement agency or other authorized facility may charge the applicant a fee sufficient to reimburse the agency or authorized facility for the costs incurred in collecting the fingerprints.

(c) Upon receipt of the electronic fingerprints as provided in this section, the Department of Justice shall determine whether the individual has been convicted of any crime and forward the information to the board. The Department of Justice's determination will be based on the Department's own data base as well as the Federal Bureau of Investigation's data base.

(d) Once the fingerprints have been entered into the system, the Department of Justice will continue to monitor the status of each individual to determine if a criminal conviction has occurred. If a criminal conviction is identified, the Department of Justice will forward the information to the board.

Additional HIPP 2000 Proposals

Proposed Study of Licensee Pool

The specific proposals presented to the Executive Committee on August 11, represent an incremental approach to legislative reform. We recognize, however, that systems approaches are often more effective than incremental approaches. But, as we reviewed the problems facing California homeowners interacting with the construction industry, and as we prepared for Sunset Review, we found we lacked the information needed to propose system-wide reform.

For example, we do not know how to structure a response to unwarranted liens. Most remedies brought forward in the past have been rejected as being at once too big and too small. Most remedies are thought to be too big because they usually require financial participation from contractors who are demonstrably not the problem. Assemblyman Honda's new Recovery Funds is such an example. All contractors would pay a fixed amount regardless of their share of the market or whether they would ever trigger a pay out.

Most remedies are also thought to be too small. For example, the Honda bill addresses the lien plight of homeowners threatened by liens who have paid in full. While these consumers can certainly demonstrate significant injury, many other consumers can demonstrate much worse conditions. For example, the contractor hires a sub to rip the roof off. The homeowner pays the down payment and a progress payment. The contractor does not pay the sub and abandons the project. The sub files a lien. This homeowner would not qualify for the fund: the homeowner did not pay in full. Thus, the Honda recovery fund may be too small.

We recognize that, in order to develop (or reject) a systems approach to the prevention and/or remediation of financial injury to homeowners, CSLB needs much more information about its pool of licensees. We need a comprehensive picture of the licensing pool to compare with the pool of contractors disciplined.

This type of study would allow CSLB to embrace or reject, for example, a step licensing approach. One model of step licensing will be discussed at the Executive Committee.

This discussion is included here in order to alert the board to the possibility that, in meetings to come, we may ask the Board to consider a system-wide approach for HIPP 2000 in addition to the proposals included herein.

NOTICE TO OWNER
PROVIDED IN ACCORDANCE WITH
SECTION 7018.5 OF THE BUSINESS AND PROFESSIONS CODE

Under the California Mechanics' Lien Law, any contractor, subcontractor, laborer, supplier, or other person or entity who helps to improve your property, but is not paid for his or her work or supplies, has a right to place a lien on your home, land, or property where the work was performed and to sue you in court to obtain payment.

This means that after a court hearing, your home, land, and property could be sold by a court officer and the proceeds of the sale used to satisfy what you owe. This can happen even if you have paid your contractor in full if the contractor's subcontractors, laborers, or suppliers remain unpaid.

To preserve their rights to file a claim or lien against your property, certain claimants such as subcontractors or material suppliers are each required to provide you with a document called a "Preliminary Notice." Contractors and laborers who contract with owners directly do not have to provide such notice since you are aware of their existence as an owner. A preliminary notice is not a lien against your property. Its purpose is to notify you of persons or entities that may have a right to file a lien against your property if they are not paid. In order to perfect their lien rights, a contractor, subcontractor, supplier, or laborer must file a mechanics' lien with the county recorder which then becomes a recorded lien against your property. Generally, the maximum time allowed for filing a mechanics' lien against your property is 90 days after substantial completion of your project.

TO INSURE EXTRA PROTECTION FOR YOURSELF AND YOUR PROPERTY, YOU MAY WISH TO TAKE ONE OR MORE OF THE FOLLOWING STEPS:

(1) Require that your contractor supply you with a payment and performance bond (not a license bond), which provides that the bonding company will either complete the project or pay damages up to the amount of the bond. This payment and performance bond as well as a copy of the construction contract should be filed with the county recorder for your further protection. The payment and performance bond will usually cost from 1 to 5 percent of the contract amount depending on the contractor's bonding ability. If a contractor cannot obtain such bonding, it may indicate his or her financial incapacity.

(2) Require that payments be made directly to subcontractors and material suppliers through a joint control. Funding services may be available, for a fee, in your area which will establish voucher or other means of payment to your contractor. These services may also provide you with lien waivers and other forms of protection. Any joint control agreement should include the addendum approved by the registrar.

(3) Issue joint checks for payment, made out to both your contractor and subcontractors or material suppliers involved in the project. The joint checks should be made payable to the persons or entities which send preliminary notices to you. Those persons or entities have indicated that they may have lien rights on your property, therefore you need to protect yourself. This will help to insure that all persons due payment are actually paid.

(4) Upon making payment on any completed phase of the project, and before making any further payments, require your contractor to provide you with unconditional "Waiver and Release" forms signed by each material supplier, subcontractor, and laborer involved in that portion of the work for which payment was made. The statutory lien releases are set forth in exact language in Section 3262 of the Civil Code. Most stationery stores will sell the "Waiver and Release" forms if your contractor does not have them. The material suppliers, subcontractors, and laborers that you obtain releases from are those persons or entities who have filed preliminary notices with you. If you are not certain of the material suppliers, subcontractors, and laborers working on your project, you may obtain a list from your contractor. On projects involving improvements to a single-family residence or a duplex owned by individuals, the persons signing these releases lose the right to file a Mechanic's lien claim against your property. In other types of construction, this protection may still be important, but may not be as complete.

To protect yourself under this option, you must be certain that all material suppliers, subcontractors, and laborers have signed the "Waiver and Release" form. If a mechanics' lien has been filed against your property, it can only be voluntarily released by a recorded "Release of Mechaincs' Lien " signed by the person or entity that filed the mechanics' lien against your property unless the lawsuit to enforce the lien was not timely filed. You should not make any final payments until any and all such liens are removed. You should consult an attorney if a lien is filed against your property.

AMENDED IN ASSEMBLY APRIL 5, 1999

AMENDED IN ASSEMBLY MARCH 11, 1999

CALIFORNIA LEGISLATURE—1999–2000 REGULAR SESSION

ASSEMBLY BILL No. 171

Introduced by Assembly Member Margett

January 15, 1999

An act to add Section 3258.5 to the Civil Code, relating to works of improvement.

LEGISLATIVE COUNSEL'S DIGEST

AB 171, as amended, Margett. Works of improvement: liens.

Existing law governs public and private works of improvement. Among other things, these provisions require that the owner of the work of improvement sign and verify any notice of completion or notice of cessation and that the notice be recorded in the office of the county recorder of the county in which the site is located.

This bill would require the owner of a public or private work of improvement to notify, by *registered or* certified mail, the original contractor, and any claimant who has ~~filed~~ *provided* a preliminary 20-day notice, that a notice of completion or notice of cessation has been recorded within ~~5~~ *10* days of recordation of that notice of completion or notice of cessation. *The bill would provide that failure to give notice shall extend the period of time in which the contractor or claimant may file a mechanic's lien or stop notice to 90 days, as specified, which*

would be the sole liability incurred for failure to give notice. The bill would also define an owner for these purposes as a person who has an interest in real property, or his or her successor in interest, as specified, but would exclude a person who occupies the real property as his or her personal residence.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

SECTION 1. Section 3258.5 is added to the Civil Code, to read:

3258.5. The owner of a private or public work shall notify the original contractor, and any claimant other than the original contractor who has ~~filed~~ *provided* a preliminary 20-day notice in accordance with the provisions of Section 3097 or 3098, that a notice of completion or notice of cessation has been recorded. *The notice shall be sent* within ~~five~~ *10* days after recordation of ~~that~~ *the* notice of completion or notice of cessation. ~~That notification~~ *Notification* shall be sent by *registered or* certified mail. *Failure to give notice to any contractor or claimant within 10 days of recording the notice of completion or notice of cessation shall extend the period of time in which that contractor or claimant may file a mechanic's lien or stop notice. That period shall be 90 days beyond completion of the work of improvement or cessation of activity. The sole liability for failing to give notice shall be the extension of the period of time in which that contractor or claimant may file a mechanic's lien or stop notice.*

For purposes of this section, "owner" means a person who has an interest in real property, or his or her successor in interest at the date of a notice of cessation from labor is filed for record, who causes a building, improvement, or structure, to be constructed, altered, or repaired on the property, *but does not include a person who occupies the real property as his or her personal residence*. Where the property is owned by two or more

persons as joint tenants or tenants in common, any one or more of the cotenants may be deemed to be the "owner" within the meaning of this section. "Owner" shall not include any person who has a security interest in the property or obtains an interest pursuant to a transfer described in subdivision (b), (c), or (d) of Section 1102.2.

O