Study H-820 April 4, 2000

Memorandum 2000-26

Mechanic's Liens: Issues and Other Approaches

This memorandum reviews different approaches to protecting the owner's interest, particularly the homeowner, from attachment of mechanic's liens. In a study of this sort, the Commission typically reviews a range of approaches to revising the law, even if the end result is a recommendation for minor substantive and technical changes in existing law. This is an important exercise in order to find useful ideas for possible reforms, even if the existing law is retained in largely its present form. In addition, it is worth remembering that the referral from the Assembly Judiciary Committee asked the Commission to provide a "comprehensive review of this area of the law, making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions." (See Letter from Assembly Members Sheila James Kuehl (Chair) and Rod Pacheco (Vice Chair), June 28, 1999, attached to Memorandum 99-85.)

The following materials are attached:

Exhibit p.

1. Valery P. Loumber, Memorandum, "Mechanic's Liens, Protecting the Homeowner" (Inst. Legis. Prac. Feb. 15, 2000) [reformatted] 1
2. Letter from Assemblyman Bob Margett, re AB 171 (Feb. 23, 2000) 5
3. AB 2113 (Honda) — Homeowners Protection Act 7
4. Prefatory Note, Uniform Construction Lien Act (1987) 17

(Unless otherwise indicated, statutory references in this memorandum are to the Civil Code.)

Introduction

At the February meeting, the Commission requested a review of statutory approaches in other states. The staff has not had time to review the statutes of all the other states. Secondary sources indicate that there is a wide variety in the details of mechanic's lien statutes, but not many variations in broad terms. Some of these variations are noted in the following discussion. Our preliminary conclusion, however, is that not much will be gained by sifting through most state's statutes in this area, either because the state's law is far behind California's in its development, or because it has been (and is being) developed through the

same struggle between competing stakeholders. The staff intends to look at other statutes of particular note — larger commercial states (e.g., New York, Pennsylvania, Michigan), recently revised statutes (e.g., Florida, Massachusetts), and neighboring states — for useful ideas when we get to the stage of considering different elements of California law.

Discussions at the last two Commission meetings have centered on the issue of potential double payment by homeowners who have paid the prime contractor but then face the lien claims of subcontractors and material suppliers who have not been paid by the prime contractor. We will continue to assess the significance of this problem, but it is interesting to see how often the issue is mentioned in the literature. For example, the subtitle of the Nolo Press Guide to mechanic's liens is "Get Paid If You're a Contractor — Don't Pay Twice If You're a Homeowner." The Prefatory Note to the Uniform Construction Lien Act discusses three major issues: who is entitled to a lien, priorities, and protection of owners who have paid the prime contractor without notice that another mechanic's lien claimant hasn't been paid. (See Exhibit p. 22. "The 20-day notice requirement, patterned after the California lien law, however, does give the owner substantial protection against double payment.") We have not discovered any empirical data in California or elsewhere that would demonstrate the degree of the problem under current law.

The potential "double-payment" problem does not afflict only homeowners. The other side of the coin is the problem faced by subcontractors and material suppliers who have not been paid by the prime contractor or a subcontractor. Fundamentally, the problem involves who will bear the risk of nonpayment by the prime contractor or by a subcontractor higher in the payment chain, where the owner has made full payment.

The purpose of this memorandum is to summarize the known remedies and report on approaches taken in other states. We have not uncovered any magic bullet solutions. Most of the options have already been discussed at prior Commission meetings or mentioned in materials presented to the Commission:

- **Notice and education** — the Civil Code provides highly detailed (though apparently still inadequate) notices; the Contractors State License Board has been working on improving notices in their HIPP 2000 initiative.
- **Licensing bonds, penalties, and enforcement** — regulatory efforts can improve protection through a number of means.

- **Payment bonds** — a bond can be substituted for the lien protection, as an option or mandatory, but it is generally agreed that this is not a realistic solution for homeowners.
- **Lien recovery funds** — CSLB reports that two states (Michigan and Utah) have this type of fund (12 or more have funds for recovery of actual damages); a lien recovery fund is the subject of AB 2113 (Honda) (copy attached as Exhibit pp. 7-16).
- **Joint checks, installment payments, lien waivers** — these techniques are available to the knowledgeable owner who can successfully negotiate appropriate terms. See Loumber Memorandum, Exhibit pp. 1-2.
- **Escrow or joint control** — mentioned at the February meeting, using an escrow or jointly controlled fund could be encouraged or required for certain contracts.
- **Retainage** — payments can be held back to ensure payment or clearance of potential liens.

Several of these options are discussed in more detail below.

At this meeting, we would like to tentatively determine which major consumer protection (or broader) options to pursue, if any. The staff can then focus on developing draft language and dealing with the technical issues that inevitably arise. Regardless of the outcome on the homeowner double payment issue, we need to start making progress on other issues involving the existing mechanic's lien statute — such as those raised by Gordon Hunt in his reports attached to earlier memorandums, letters received from a number of individuals, and law review articles. These issues provide fodder for the bills introduced each year, and are presumably a major factor in the Assembly Judiciary Committee's referral. There are a number of mechanic's lien related bills pending this year. (For example, see Assemblyman Margett's letter, attached as Exhibit pp. 5-6.)

Terminology

If possible, it is useful to find the best terms at the beginning, rather than revising terminology from time to time during the project.

1. "Mechanic"

A preliminary issue — not of major consequence, but something people may feel strongly about — concerns the common name of the lien itself. One of the first things the strikes a newcomer to this area is the oddity of the term "mechanic." In fact, many articles about mechanic's liens, particularly in introductory material, enclose the word in quotation marks.

The Commission may want to dispose of the issue of whether to recommend changing the name of the lien. The term "mechanic" had a different common understanding 100 or 200 years ago than it does now. If for no other reason, the California "mechanic's lien" logically derives as a shorthand for the constitutional provision (Cal. Const. art IV, § 3):

> 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.

The first paragraph of the Nolo Press Guide, *supra*, reads:

> To begin at the beginning, mechanics' liens have nothing to do with automobile mechanics. Rather they are used to collect debts owed for work or materials contributed to construction and real estate improvement. However, if an auto mechanic contributes to the improvement of real estate, the mechanic can use this remedy as well as a carpenter, plumber or electrician — if, for instance, an auto mechanic repairs an earth mover or dump truck being used on a construction project.

The Prefatory Note to the Uniform Construction Lien Act (1987) reports:

> This title, suggested by a Wisconsin modification of its mechanics' lien laws, is adopted because the title "Mechanics' Liens" improperly implies that laborers are the primary beneficiaries of mechanics' lien laws. With the payment of wages weekly or bi-weekly by contractors (as is the universal custom today) wage claimants no longer loom large in mechanics' lien situations.

Should we stick with the traditional term or adopt, if only tentatively, the term "construction lien"?

2. "Original Contractor"

The mechanic's lien statute generally uses the term "original contractor" when referring to a contractor with a direct contractual relationship with the owner. SeeSection 3095 (definition). Common parlance and most articles we have seen tend to use "prime contractor" or "general contractor." "Prime" and "general" imply subcontractors, which is the usual case involving mechanic's liens. These terms would be inaccurate if there is no subcontractor, but the term "original contractor" seems even less desirable. Since the statute distinguishes in

several places between contractors with a direct contract, perhaps "direct contractor" would be a better term than "original contractor."

Should we continue to use "original contractor" in the statute, or replace it with "prime contractor" or "direct contractor" if the statute is redrafted?

California Statute: Extent of Lien and Preliminary Notice

California law provides a broad mechanic's lien right, extending from prime contractors, through subcontractors and sub-subcontractors down the line, and to equipment and material suppliers. See Cal. Const. art IV, § 3; Civ. Code § 3110. Section 3110, which is broader than the constitutional language quoted above, grants a lien to the following persons — constitutional classes are in bold type:

> **Mechanics**, **materialmen**, contractors, subcontractors, lessors of equipment, **artisans**, architects, registered engineers, licensed land surveyors, machinists, builders, teamsters, and draymen, and all persons and **laborers of every class** performing labor upon or bestowing skill or other necessary services on, or furnishing materials or leasing equipment to be used or consumed in or furnishing appliances, teams, or power contributing to a work of improvement ….

The mechanic's lien does not cascade down the line forever. Only the first of a string of material suppliers has a lien., i.e., the one who supplies to the owner, prime contractor, or a subcontractor. A supplier of material to another material supplier does not have a lien. See, e.g., *Piping Specialities Co. v. Kentile, Inc.*, 229 Cal. App. 2d 586, 40 Cal. Rptr. 537 (1964).

In partial fulfillment of its constitutional duty to "provide, by law, for the speedy and efficient enforcement" of mechanic's liens, the Legislature has provided a number of notice and procedural requirements. Most important is the 20-day preliminary notice under Section 3097, which must be given to the owner (unless the claimant is dealing directly with the owner-builder), prime contractor, and construction lender (if any), in order to preserve the right to enforce the lien or bond rights, or use the stop notice remedy. The preliminary notice may be recorded, but it is separately indexed by the country recorder and is not an interest or claim clouding title. See Section 3097(o)(5).

The effect of the preliminary notice procedure is to bar enforcement of lien, bond, and stop notice rights under the statute for labor, equipment, or materials furnished before the 20-day period starts.

At the end of the project, to preserve enforcement rights, a claim of lien must be recorded within 90 days after completion of the contract (as to a contractor with a direct contract with the owner) or cessation of furnishing labor, services, equipment, or materials (as to other claimants). Sections 3115, 3116. If a notice of completion or notice of cessation is recorded, the applicable recording windows are 60 days(prime) and 30 days (others). Under Section 3144, generally the lien is "automatically … null and void and of no further force and effect" if an action to foreclose is not commenced within 90 days after recording. In special circumstances where credit is given, the time for filing a foreclosure action may extend to one year after completion.

Scope of Mechanic's Lien

The potential for occurrence of the double payment problem is greater where mechanic's lien rights are granted broadly, as in California. About half of the states have more restricted mechanic's lien statutes. See UCLA Prefatory Note, Exhibit p. 18. Florida, for example, excludes material suppliers. Tennessee protects homeowner by giving a mechanic's lien only to the prime contractor.

We do not intend to discuss this issue further, unless the Commission is interested in pursuing it. Part of the breadth of the California mechanic's lien is due to the constitutional language (e.g., material suppliers, laborers of every class). Even if this were not the case, any attempt to eliminate existing lien rights in favor of a segment of the construction industry would be controversial, to say the least. On the other hand, the judicially created lien in favor of architects and engineers on unbuilt projects was restricted when the Legislature enacted the design professionals lien in Sections 3081.1-3081.10. See G. Lefcoe, Real Estate Transactions 1060 (1993). A minor restriction on lien rights of persons not in privity applicable to single-family owner-occupied dwellings or contracts of a certain amount might be worth further consideration.

Distinguishing Between Sophisticated and Unsophisticated Parties

The double payment problem relates to less sophisticated owners, presumably the homeowner who may be involved in a construction project only once or twice or several times in a lifetime. It is appropriate to apply the typical line-drawing of consumer protection statutes that distinguish between single-family owner-occupied dwellings (or perhaps some other factor, such as four or

fewer units with owner occupation, or contract amount) and other construction projects. The different approaches balancing competing interests

At least one prominent commentator does not find the sophistication argument convincing. Sam Abdulaziz has written: "Our experience would indicate that the contractors that are performing this type of work are not more sophisticated in the process than the typical owner." (See Memorandum 2000-9, Exhibit p. 17.)

Options or Mandatory Provisions?

Effect of a particular remedy or procedure depends in part on the other parts of the statute, as well as economic conditions, custom and practice in the industries involved, and other factors. Some ostensibly useful procedures, such as bonding or escrow, may be appealing in the abstract, but become difficult to implement in practical terms.

Moreover, the utility or appeal of a particular solution may vary dramatically depending on whether it is available as one of several options or is a requirement. For example, using surety bonds is a current option, but is rarely used in smaller projects. Grafting additional options on the existing mechanic's lien scheme may not be helpful if the typical homeowner is unlikely to know of or understand the remedy, or be unwilling to pay for it or invest the time and effort to take advantage of it.

Protective Remedies

1. License Bonds

The basic licensed contractor's bond is set at $7,500. Bus. & Prof. Code § 7071.6 (swimming pool contractors need a $10,000 bond). Material and equipment suppliers are not licensed, and provide no bond. See Bus. & Prof. Code § 7052. Minor works contractors (under $500 are not required to be licensed. Bus. & Prof. Code § 7048. These levels are meaningless as a fund for homeowner protection. The amounts appear to be a minimum barrier to entry. Contractors who get in trouble will have claims and unsatisfied obligations far exceeding these low amounts. Any proposal to raise contractor bonds to a meaningful amount would face substantial opposition and raise the bar on entry into the contracting business for everyone. (As discussed below, the $7,500 bond would be repealed by SB 1524.)

2. Payment Bonds

Several types of bonding options exist: performance bonds, payment bonds, release bonds, etc. A contractor can get a payment bond to cover payments to subcontractors, for example. Subcontractors can get a bond to guarantee payment to sub-subcontractors and material suppliers. An owner can seek a bond to substitute for the mechanic's lien remedy. Sections 3235-3236 provide protection against lien claimants where a bond in the amount of 50% of the contract price is recorded, along with the contract, before work commences. But on small projects and in the home improvement area, bonds are not a practical option. The cost of a bond can be 1-5%, some subcontractors may have difficulty qualifying, and human nature is to avoid the trouble and expense of a bond until it is too late. Mandating payment bonds would add to the paperwork and expense of home improvement contracts.

As to payment bonds, Prof. George Lefcoe points out that

> Bonding is needed most when it is least likely to be available. Small and undercapitalized contractors do modest-sized jobs for individual property owners on tight budgets. In these situations, few contractors have the credit necessary to get a bond. The costs of such bonds as are available will be prohibitive to the owner and the contractor.

G. Lefcoe, *Mechanics Liens*, in Thompson on Real Property § 102.02(a)(2)(i), at 560 (Thomas ed. 1994). He believes that the recorded bonded contract option under Civil Code Section 3235 "offers the best protection for the owner, but is the least often used because few owner know about it and, in any event, bonding is a costly and bureaucratic exercise for the novice." *Id.* § 102.02(a)(2)(iv), at 562.

The Nolo Guide gives little attention to payment bonds, since they are "not a viable option for most small property owners." Nolo, *supra* at 9/13. As to the recorded contract and bond under Section 3235, the Nolo Guide says:

> Although this approach to reducing mechanics lien risk may seem like a good idea, most general contractors will not qualify for a payment bond equal to 50% of the overall project cost.... [In a $100,000 project example] the cost of the bond would be somewhere in the neighborhood of $10,000, which would be economically unfeasible as well. 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 be absorbed in the larger project.

(*Id.* at 9 / 12-9 / 13.)

Gordon Hunt suggested serious consideration of mandatory payment and performance bonds, instead of a recovery fund, in Part 2 of his report (attached to Memorandum 2000-9, p. 10):

> [A]nother 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.

Mr. Hunt also recommended adoption of the "mini-performance bond" under consideration by CSLB as part of its developing Home Improvement Protection Plan (HIPP 2000). The mini-performance bond proposal was outlined as follows in the August 11, 1999, HIPP 2000 draft (see Hunt Report Part 2, Exhibit p. 27):

- 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.…

The mini-performance bond proposal, developed by the Association of California Surety Companies, was removed from the HIPP 2000, in light of the Commission's project. Without having studied the matter in detail, the staff thinks the mini-performance bond is worth pursuing, although it appears that legislative forces may be moving in the opposite direction in SB 1524 (Figueroa), which would replace the existing $7,500 general license bond with a $100,000 liability insurance requirement. Still, a special bond for home improvement contractors might be appropriate, but we also understand that the surety companies have now abandoned their proposal. (It should also be noted that the HIPP 2000 proposal has not been included in any bill this year.)

Section 3143 permits the owner to release property from a mechanic's lien by posting a bond in the amount of 1.5 times the lien claim. This option permits the owner to clear title, but of course does nothing to avoid double payment problems.

3. Joint Checks

Joint checks issued to the prime contractor and subcontractor (or some other combination of potential lien claimants) are a recognized means for attempting to avoid double payment problems. This approach was recognized in *Bentz Plumbing & Heating v. Favalaro*, 128 Cal. App. 3d 145, 151-52, 180 Cal. Rptr. 223 (1982); see also Acret, *Representing the Prime Contractor*, in California Mechanics' Liens and Related Construction Remedies § 7.43 (Cal. Cont. Ed. Bar, 3d ed. 1999). Joint checks are not certain, however, because endorsement may take place without any payment from the co-payee or the check may bounce. Joint checks are not equivalent to obtaining a release.

Perhaps joint checks need to be put on a firmer footing. In Arizona, when a material supplier endorses a check he "will be deemed to have been paid the money due him, up to the amount of the joint check so long as there is no other agreement between the owner or general contractor and the materialman as to the allocation of the proceeds." See case cited in G. Lefcoe, Real Estate Transactions 1050 n.25 (1993).

4. Escrow, Joint Control

In California, joint control agents are subject to the same regulatory scheme as escrow agents, and are licensed by the Department of Corporations. See, e.g., Fin. Code §§ 17000 (Escrow Law), 17005.1 ("joint control agent" defined), 17202 (bond). One aspect of the HIPP 2000 proposal was to outline options such as joint control services in an effort to educate homeowners.

It is assumed that very few homeowners use joint control agents. Is there a class of contracts where joint control should be required or encouraged by some procedural incentive? Like bonding, this would add an expense to all such cases, regardless of whether any protection was needed. We understand that the fees of joint control agents may be about the same as for surety bonds, in the 1-5% range.

5. Retainage, Retention Payments

Retainage is holding back part of the payment to make sure that subcontractors and material suppliers have been paid by the prime contractor. If a sufficient amount is held back, this might offer a simple way to deal with the typical (if there is such a thing) sort of potential double payment problem. The retainage period would be for the time for filing lien claims, so that the owner can determine in fact whether subcontractors and suppliers have been paid. California has detailed statutes on "retention proceeds," progress payments, and prompt payment that would have to be revised. See Civ. Code § 3060 *et seq.*; see also Bus. & Prof. Code § 7159 (home improvement contracts). Unless retainage is mandated for certain types of contracts, it would not address the double payment problem, since it arises where the owner has not retained payments. For example, in Texas, the owner is required to retain 10% of the contract price of improvements until 30 days after completion. Tex. Prop. Code § 53.101 (Westlaw 2000). The lien claimant has a lien on the retainage by sending proper notice and filing an affidavit within 30 days after completion. *Id.* §§ 53.102, 53.103.

6. Recovery Fund

Fifteen states have some sort of general recovery fund that substitutes for the mechanic's lien rights of subcontractors' and material suppliers' who have not been paid by the prime contractor. As the Commission knows, this approach was proposed in Assembly Member Honda's AB 742 introduced last year. A revised proposal is before the Legislature in Assembly Member Honda's AB 2113. (See Exhibit pp. 7-16.) In light of the current and recent legislative attention to these bills, the staff is not suggesting Commission review of these options. We are

aware of the option of recovery funds, and in the future, depending on the outcome of AB 2113, it may be appropriate for the Commission to revisit the issue. For the time being, however, the staff does not intend to devote further resources to analyzing or developing recovery fund options, since it would only duplicate ongoing legislative activity.

7. Subcontractor Election

In discussions with the staff, Ellen Gallagher, Staff Counsel, CSLB, outlined an interesting approach that would play off the existing preliminary notice scheme, but would make the notice from a subcontractor more relevant. The subcontractor, or any potential lien claimant not in privity with the owner, would have the choice of either (1) giving a notice to the owner that requests the owner to pay directly to the subcontractor or face the potential of a lien or (2) being under the prime contractor's lien umbrella with no separate lien against. This would enable the homeowner to pay the prime contractor, in the absence of a notice, with confidence that there will be no double payment problem. The existing practice, as we understand it, is for all subcontractors to give the preliminary notice so they can lock in their potential lien claims. This strikes the staff as being wasteful of paper and probably confusing to the homeowner, since it is not clear what should be done upon receipt of a notice. A direct statement that the owner is to pay funds to the subcontractor or retain funds for payment to the subcontractor would be more consequential.

We understand that prime contractors would object that they need to control subcontractors and so need to control payments. Perhaps there is a way to link the risks of nonpayment with the lien and control rights. If a prime contractor refuses to allow direct payment, the risk of the prime contractor's insolvency or nonpayment to subcontractors should not shift to the homeowner. One way to deal with the issue is to set up a waiver upon payment system.

Full Payment Defense

The potential for double payment was probably infinitesimal when the mechanic's lien first emerged in California, but the construction industry has changed dramatically in 150 years. The mechanic's lien originated when construction was in the hands of a master builder and his employees and apprentices. (Remember that the California constitutional provision does not provide a lien for "contractors," but only for mechanics, artisans, and laborers, as well as material suppliers.) Historically, the lien functioned to ensure payment at

a time before most construction projects were financed. The social and economic purpose served by the mechanic's lien was to enable the workers and suppliers to self-finance construction projects through reliance on their lien rights, before the development of multiple tiers of subcontractors, equipment and material providers, and sophisticated financing practices. Once upon a time, the owner could pay the contractor in full and be done with it. There was no double payment risk.

One solution to the potential double payment problem is to honor the sense of the original mechanic's lien and provide that a homeowner's full payment in good faith to the prime contractor is a defense against further mechanic's lien claims from anyone not in privity with the owner. James Acret has discussed this approach as an alternative to Assembly Member Honda's lien recovery fund in AB 742. (See Second Supplement to Memorandum 2000-9, Exhibit pp. 15-19.) Mr. Acret argues that the constitution

> does not prevent the legislature from establishing defenses to mechanics lien claims in support of public policy. An example of such policy is legislation that prohibits unlicensed contractors from enforcing a claim of mechanic's lien even for the value of work properly performed. The legislature could likewise prevent the enforcement of lien claims against homeowners who have already paid for the work and materials supplied to their projects.
>
> The fairness of this proposal is easily supported. Merchants who advance credit assume the risk of nonpayment. Only in the construction industry is a merchant who makes a bad credit decision (by extending credit to an unworthy contractor) protected. It is unfair to extend such protection at the expense of an innocent homeowner who has fulfilled all contractual obligations to pay for improvements. In such cases, it should be the merchant, and not the homeowner, that takes the loss.

(Second Supplement to Memorandum 2000-9, Exhibit pp. 15-16.)

In New York, the lien is limited to the unpaid amount:

> If labor is performed for, or materials furnished to, a contractor or subcontractor for an improvement, the lien shall not be for a sum greater than the sum earned and unpaid on the contract at the time of filing the notice of lien, and any sum subsequently earned thereon. In no case shall the owner be liable to pay by reason of all liens created pursuant to this article a sum greater than the value or agreed price of the labor and materials remaining unpaid, at the time of filing notices of such liens ….

N.Y. Lien Law § 4 (Westlaw 2000). Maine has a similar rule, apparently by virtue of case law. See Lefcoe, Real Estate Transactions, *supra*, at 1049 n.17.

Uniform Construction Lien Act

The UCLA and its parent act, the Uniform Simplification of Land Transfers Act, have not met with much success. We understand that only Nebraska has enacted UCLA in substantial portion, although a number of other states have adopted parts of it. The UCLA has now been "demoted" to model act status. One commentator noted that the UCLA failed because it couldn't avoid balancing the same interests each state has struggled with historically; negotiations throughout the drafting process failed to produce a consensus on the most equitable treatment of construction liens. See Dysart, *USLTA: Article 5 "Construction Liens" Analyzed in Light of Current Texas Law on Mechanics' and Materialmen's Liens*, 12 St. Mary's L.J. 113, 116-17 (1980). We hope the Commission can avoid these pitfalls in working to improve the California statute. Like other state statutes, however, we intend to use the UCLA as a source for policy comparisons and drafting ideas. The staff is not proposing to embark on a project of promoting the UCLA.

The Prefatory Note from the Uniform Construction Lien Act (UCLA), which gives an overview of its major features, is attached. (See Exhibit pp. 17-23; the full UCLA numbers 90 pages.) For our present purposes, it is interesting to note that the Uniform Commissioners felt it necessary to provide two alternatives on the issue whether the "owner [is] protected in making payments to the prime contractor, if, at the time he pays, he has no notice that a mechanics' lien claimant claiming under the prime has not been paid." (See Exhibit p. 22.) The first alternative resembles James Acret's proposal discussed above: "An owner's real estate is subject to the liens of claimants below a prime contractor only to the extent that the owner has not paid the prime contractor at the time he receives notice from the claimant of the prospective lien claim." The second alternative is based (somewhat reluctantly) on California law:

> Under the second alternative, a claimant below a prime contractor can assure himself of a lien against the owner for his full contract price by notifying the owner within 20 days after the claimant first furnishes services or materials. If the claimant so notifies the owner, the owner cannot defend that he had already paid the prime contractor at the time he received the notice. The 20-day notice requirement, patterned after the California lien law, however, does give the owner substantial protection against double payment.

Constitutional Issues

Depending on the direction of the Commission's study, we will need to investigate the constitutional issues. Gordon Hunt has given his opinion of the effect of the constitutional status of the mechanic's lien in California in his reports. James Acret assesses the situation differently, as noted above. Until specific proposals are fashioned, it is premature to delve into the cases and try to draw any more refined conclusions. Although the constitutional language is fairly broad, the courts have recognized that the Legislature can prescribe reasonable requirements for lien enforcement.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

M E M O R A N D U M

To: Professor J. C. Kelso
From: Valery P. Loumber
Date: February 15, 2000

Re: Mechanic's Liens, Protecting the Homeowner

Introduction

The following memorandum deals with different ways to protect a homeowner from paying twice for work done by a subcontractor because the primary contractor failed to pay the subcontractor. The problem arises after the homeowner has paid the primary contractor and the primary contractor, usually because of insolvency, is unable to pay the subcontractor. To collect, the subcontractor turns to mechanic's lien laws. Where mechanic's lien laws allow the subcontractor to collect from the homeowner regardless of whether the homeowner has paid the primary contractor, the homeowner pays twice for the subcontractor's work; once to the primary contractor, and once more to the subcontractor.

First, this memorandum outlines what homeowners can do to protect themselves. Second, the memorandum describes how mechanic's lien laws can be shaped to impose statutory duties on subcontractors to protect homeowners. Finally, this analysis explores how mechanic's lien laws can be shaped to impose statutory duties on primary contractors to protect homeowners. This memorandum is not a comprehensive overview of the mechanic's lien laws of all 50 states.

I. What Can Homeowners Do to Protect Themselves from Paying Twice for the Subcontractors' Work?

1. Joint Checks

One way a homeowner can make sure that the primary contractor pays his subcontractor is by issuing a joint check in the name of both the primary contractor and his subcontractor. *See Flintkote Company v. Presley of Northern California*, 154 Cal. App. 3d 458 (1st Dist. 1984). The primary contractor would not be able to cash the check without the subcontractor, forcing him to obtain the subcontractor's signature before collecting his share of the payment. 53 Am. Jur. 2d *Mechanics' Liens* § 321 (1999). Hopefully, the subcontractor will receive his share of the payment when they cash the joint check. However, joint checks do not always eliminate the risk that the primary contractor will fail to pay his subcontractor. Sometimes subcontractors allow primary contractors to cash a joint check merely for the primary contractor's promise that he will pay the subcontractor later. Moreover, the mere endorsing of a check does not always prevent the subcontractor from pursuing a mechanic's lien claim against the homeowner. *See id.* (citing *Brown Elec. Wholesale Elec. Co. v. Beztak of Scottsdale*, 788 P.2d 73 (1990).). Therefore, in such instances, the homeowner has the same risk of paying twice for the subcontractor's work as if he had not even issued the joint check.

2. Express Condition Precedent

In his contract with the primary contractor, the homeowner can seek to pay the primary contractor in installments. In a single subcontractor situation, the homeowner's first installment to the primary contractor would be only what's due the subcontractor. In negotiating the contract with the primary contractor, the homeowner can demand that the primary contractor's payment to the subcontractor be an express condition precedent to the homeowner paying the primary contractor for his work. A party must fulfill express conditions at the least substantially (in most cases express conditions must be fulfilled fully and literally) before the duty of the opposing party to perform arises. *See Petersen v. City of San Diego,*

77 Cal. App. 4th 582, 594 (4th Dist. 2000). Hence, if the primary contractor fails to pay the subcontractor, under the contract with the primary contractor, the homeowner would not be obligated to pay him for his work.

3. Lien Waivers

To protect themselves, homeowners can also seek lien waivers from subcontractors. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 119 (1985). Although subcontractors are statutorily given mechanic's lien rights, subcontractors can give up their lien rights by contracting them away. *Id.* (citing *Herbert & Brooner Constr. Co. v. Golden*, 499 S.W.2d 541 (Mo. Ct. App. 1973). Lien waivers are agreements between the homeowner and the subcontractor, providing that the subcontractor will not assert a lien claim against the homeowner's property. Unif. Simplification Land Transfers Act § 5-214 U.L.A. 14 (1990). Usually, states require the intent of waiver to be clearly shown. *See, e.g., Herbert & Brooner Constr. Co. v. Golden*, 499 S.W.2d 541 (Mo. Ct. App. 1973). Some statutes require the homeowner to give consideration for the subcontractor's waiver or detrimentally change position relying on the waiver. *See id.*; *see also* Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 119-20. Some states may not even require consideration. *See, e.g.*, Unif. Simplification Land Transfers Act § 5-214 U.L.A. 14 (1990). In reality, however, how many subcontractors would sign a waiver of their mechanic's lien rights?

II. Imposing Statutory Duties on Subcontractors to Protect Homeowners

1. Direct Lien Right Period after the Completion of Work

In protecting the homeowner, states may consider the following statutory scheme. During a 60-day period (may vary) after the completion of the work by the subcontractor, the subcontractor has a direct lien right on the homeowner's property. Roger W. Stone, *Mechanic's Liens in Iowa*, 30 DRAKE L. REV. 39, 80 (1981). A direct lien right means that the subcontractor may successfully claim a lien, regardless of whether the homeowner has paid the primary contractor. *Id.* (citing *Des Moines Furnace & Stove Repair Co. v. Lemon*, 56 N.W.2d 923, 927-28 (1963).); *see, e.g.*, Iowa Code § 572.13 (1987). The homeowner can not use his payment to the primary contractor as a defense to the direct lien claim. Roger W. Stone, *Mechanic's Liens in Iowa*, 30 DRAKE L. REV. 80. To avoid paying twice, however, during the 60-day period the homeowner does not have to pay the primary contractor. *Id.* If the homeowner pays the primary contractor within the 60 days after completion, he risks paying twice for the subcontractor's work because payment to the primary contractor would not be a defense against a direct lien claim by the subcontractor. *Id.*

The status of the subcontractor's lien right after the 60-day period depends on what the subcontractor does during the 60-day period. *See id.*; *see, e.g.*, Iowa Code § 572.14 (1987). During the 60-day period the subcontractor has a choice. Roger W. Stone, *Mechanic's Liens in Iowa*, 30 DRAKE L. REV. 80. The subcontractor can preserve his direct lien right beyond the 60 days by satisfying certain statutory requirements or forego his direct lien right by doing nothing. *Id.* If the subcontractor preserves his direct lien right and the homeowner still hasn't paid the primary contractor, the homeowner is forced to somehow ensure that the primary contractor pays his subcontractor. *See id.* If the subcontractor preserves his direct lien right and the homeowner has paid the primary contractor, the homeowner is at a risk of paying twice for the subcontractor's work because payment to the primary contractor is not a defense to a direct lien right. *Id.*

On the other hand, if the subcontractor foregoes his direct lien right, he is left only with a derivative lien right against the homeowner. *Id.* Therefore, if the subcontractor only has a derivative lien right, the homeowner can pay the primary contractor without worrying about paying twice because payment to the primary contractor is a defense against a

derivative lien claim. *Id.* For the pros and cons of the direct lien right period *see* Roger W. Stone, *Mechanic's Liens in Iowa*, 30 DRAKE L. REV. 81-82.

2. Consent Forms

States allowing subcontractors to pursue mechanic's liens, despite the homeowner's payment to the primary contractor, may require a consent form from the subcontractor. *See, e.g.*, Mo. Ann. Stat. § 429.013(2) (West 1990). The consent form consists of the homeowner's statement that he consents to the filing of a mechanic's lien by the subcontractor. *See id.* The consent form is a condition precedent to the existence, creation, and validity of a lien by the subcontractor. *See id.* Subcontractors must attach the consent form to their recorded lien claim. *See id.* The consent form gives subcontractors a direct mechanic's lien right on the homeowner's property. A direct lien right means that the homeowner can not defend a mechanic's lien filed with a consent form on the basis that he has already paid the primary contractor. 53 Am. Jur. 2d *Mechanics' Liens* § 8 (1999).

In contrast, mechanic's liens filed without a consent form give the subcontractor merely a derivative lien right. *Id.* A derivative lien right means that the subcontractor's lien claim depends on whether and to what extent the homeowner has paid the primary contractor. *Id.* Therefore, the homeowner can successfully defend a lien wanting a consent form with his payment to the primary contractor. *See* Mo. Ann. Stat. § 429.013.

However, the consent form approach to mechanic's lien laws has its disadvantages. Although the consent form is aimed at protecting the homeowner, how many subcontractors would work without such a consent form? Keith Witten & P. Blake Keating, *Recent Developments in Missouri: Mechanic's Lien Law*, 55 UMKC L. REV. 593, 595 (1987). Realistically, experienced subcontractors would always want a consent form prior to undertaking a project. *Id.*

3. Subcontractor's Statement to Homeowner

Once the subcontractor knows that he will be working for the homeowner, to protect the homeowner, states may require the subcontractor to send a statement to the homeowner, stating the name, phone number, and address of the subcontractor. *See* Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 119 (1985) (discussing part of a proposed bill). The statement must also list the work for which the subcontractor is charging and warn that a lien may be filled on the homeowner's property if the charges are not paid. *Id.* The purpose of such a statement is to warn the homeowner as early as possible of the risk that he may pay twice for the subcontractor's work.

4. Subcontractors Warning Homeowners

Another way states can better protect homeowners from paying twice for the subcontractor's work is by requiring subcontractors to warn homeowners of their existence. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 113 (1985); *see, e.g.*, Kan. Stat. Ann. § 60-1103a(c) (1987). The warning must state that: (1) there is a subcontractor; (2) the subcontractor has a right to a mechanic's lien on the homeowner's property; and (3) the homeowner has a right to seek a lien waiver from the subcontractor. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 113 (citing *Trane Co. v. Bakkalapulo*, 672 P.2d 586 (1983).). The subcontractor may mail such a warning notice to the homeowner or acquire a signed statement from the homeowner that he has notified the homeowner. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 113; *see also* Kan. Stat. Ann. § 60-1103a(b) (1987). The subcontractor's failure to communicate such a warning notice would prevent his lien claim from attaching on the homeowner's property. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 113. The purpose of this statutory scheme is

for the homeowner to learn as early as possible of all subcontractors who are potential lien claimants against his property.

III. Imposing Duties on Primary Contractors to Protect Homeowners

1. Bond Posting

To protect homeowners, states may statutorily require primary contractors to post a bond. Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 119 (1985) (citing Comment, *Mechanics' Liens and Surety Bonds in the Building Trades*, 68 YALE L.J. 138 (1958).); *see also* Unif. Simplification Land Transfers Act § 5-211 U.L.A. 14 (1990). If the primary contractor fails to pay his subcontractor, the money from the bond can be used to pay the subcontractor for his work. *Id.* Thus, the subcontractor would not need mechanic's lien laws to collect for his work. *Id.* Bond amounts may vary depending on factors such as contract price and the estimated value of the subcontractor's work. *Id.* Moreover, even if a state does not require primary contractors to post a bond, the homeowner can negotiate for the bond as part of his contract with the primary contractor.

2. Primary Contractor to Provide List of Subcontractors to Homeowner

Further, in protecting homeowners, states may require the primary contractor to provide the homeowner with a list of all the subcontractors the primary contractor has hired. Steven H. Levine, *Perfecting Mechanic's Liens: the Contractor's Duty After Malesa*, 79 ILL. B.J. 98 (1991) (discussing an Illinois statute). For each subcontractor, the primary contractor must provide the name, address, and amounts due or to become due to each subcontractor. *Id.* Some statutes may also require the primary contractor to provide the homeowner with the reasons why the list of subcontractors may file a lien claim and options the homeowner has to avoid future mechanic's lien claims (e.g., waivers, bonding, etc.). Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 114 (1985) (discussing a Missouri bill proposal).

3. Lien Fraud

Finally, to better protect homeowners, states may create the crime of lien fraud. Keith Witten & P. Blake Keating, *Recent Developments in Missouri: Mechanic's Lien Law*, 55 UMKC L. REV. 593, 595-96 (1987); *see also* Mo. Ann. Stat. § 429.014 (West 1988). Primary contractors who willfully refuse or fail to pay an undisputed debt to their subcontractors may be criminally charged. Keith Witten & P. Blake Keating, *Recent Developments in Missouri: Mechanic's Lien Law*, 55 UMKC L. REV. 595-96. The criminal charge will depend on the dollar amount involved. *See id.*

Nonetheless, the main reason why primary contractors fail to pay their subcontractors is because they are insolvent. *See* Michael J. Gorman, *Suggested Modifications to Missouri Mechanic's Lien Law as It Applies to Homeowners*, 54 UMKC L. REV. 109, 112 (1985). Hence, the crime of lien fraud will not protect homeowners from insolvent primary contractors who fail to pay their subcontractors.

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ASSEMBLYMAN, FIFTY-NINTH DISTRICT

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February 23, 2000

Mr. Stan Ulrich
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

RE: Mechanic's Lien Study, AB 171 (Margett)

Dear Mr. Ulrich:

This is in response to your request for input on the Mechanic's Lien Study that the California Law Revision Commission is currently undertaking. Your request was made during the CLRC's February 11, 2000 meeting.

I am in full agreement with Mr. Gordon Hunt's conclusion regarding my legislation, AB 171. My attention is only focused on the Notice of Completion section of the report so I will limit my comments to it.

Requiring the owner of a public or private work to notify the subcontractors, material suppliers, and contractors, as AB 171 requires, is the proverbial final piece of the notification puzzle. By requiring this, they are protected from losing their rights to a mechanic's lien because if they were aware that a Notice of Completion has been filed, they would be additionally aware that the time to file a lien would have been reduced from 90 days to 30 days for subcontractors and material suppliers (Section 3116 of the Civil Code), and 90 days to 60 days for general contractors (Section 3115 of the Civil Code). Without this additional notice to the contractors and suppliers, they're ability to perfect a mechanic's lien would be lost.

The requirements of AB 171 are predicated upon the owner taking the initiative to record a Notice of Completion, a discretionary action. It is not mandatory that the owner record a Notice of Completion. Therefore, I believe the exemption on homeowners should be removed from the bill, requiring homeowners to additionally copy a recorded notice of completion to contractors, subcontractors, and material suppliers. Homeowners, if they have the legal backing and/or knowledge of the mechanic's lien law to record a notice of completion, should also be required to copy the Notice of Completion to the contractors and material suppliers who worked on the job.

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Exempting a homeowner from the AB 171 requirement creates an awkward and illogical situation where the homeowner may still use his discretionary authority to record a Notice of Completion but be exempted from copying the notice to the contractors, subcontractors, and material suppliers. This simply causes the problem to continue.

The burden of the AB 171 requirement is on the owner born by his own action. If he records, then he should simply copy the Notice of Completion to those who it affects, the contractors, subcontractors, and material suppliers.

The opposition has continuously misinformed my office that copying the notice of completion to the contractors, subcontractors, and material suppliers is physically impossible because, in many instances, the owner does not physically know who exactly worked on the job and who supplied them with the material. The opposition has then come to the conclusion that because of this unawareness, the AB 171 requirement is impossible. While this situation may be true, it is not what the bill requires. AB 171 only requires a copy of the Notice of Completion from those entities who have filed a preliminary 20 day notice (Sections 3097 and 3098 of the Civil Code).

In the big picture of the Mechanic's Lien Law, only those contractors, subcontractors, and material suppliers who are attempting to perfect their constitutional privilege to a Mechanic's Lien should be addressed, which the law provides, and likewise those who are not interested in pursuing their Mechanic's Lien privileges should not receive a notice of completion because it is meaningless since the absence of a preliminary 20-day notice voids the privilege (Section 3114 of the Civil Code). Within the context of AB 171, the lack of a preliminary 20-day notice to the owner voids the AB 171 requirement.

I stand strongly behind the solution presented in AB 171. It is truly the final piece of the notification puzzle because it requires an action by an owner only when an action has been executed. If an owner is interested in using the law to restrict the time a contractor, subcontractor, or material supplier has to enforce a lien, then it is incumbent upon the state to require that owner to notify them. Without this notice, contractors, subcontractors, and material suppliers unfairly risk losing their constitutional privilege to a mechanic's lien.

Kindest Regards,

BOB MARGETT
Assemblyman, 59th District

BGM:tab

ASSEMBLY BILL No. 2113

Introduced by Assembly Member Honda

February 22, 2000

An act to add Article 8 (commencing with Section 3155) to Chapter 2 of Title 15 of Part 4 of Division 3 of the Civil Code, relating to mechanics' liens, and making an appropriation therefor.

LEGISLATIVE COUNSEL'S DIGEST

AB 2113, as introduced, Honda. Liens: Homeowners Protection Act.

Under provisions of the California Constitution, mechanics, persons furnishing materials, artisans, and laborers of every class are entitled to 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 is required to provide for the speedy and efficient enforcement of those liens.

Existing law specifies all persons and laborers who are entitled to a lien upon the property upon which they have bestowed labor or furnished materials or leased equipment, as specified. Existing law entitles a person to enforce such a lien only if he or she has served a preliminary 20 day notice, as specified, and prescribes the time periods in which the claim of lien must be recorded. Existing law provides that the amount of the lien shall be for the reasonable value of the labor, services, equipment, or materials furnished or for the price agreed upon, whichever is less, but that any original

contractor or subcontractor may recover only such amount as may be due under the terms of a contract, after deducting all claims of other claimants for labor, services, equipment, or materials furnished and embraced within the contract. Existing law authorizes the owner of property to petition the proper court for an order to release the property from the lien if specified conditions are met.

Existing law provides that the amount of a mechanic's lien shall be for the reasonable value of the labor, services, equipment, or materials furnished or for the price agreed upon, whichever is less, but that any original contractor or subcontractor may recover only such amount as may be due under the terms of a contract, after deducting all claims of other claimants for labor, services, equipment, or materials furnished and embraced within the contract. Existing law authorizes the owner of property to petition the proper court for an order to release the property from the lien if specified conditions are met.

This bill would require a person, other than an original contractor, who has provided labor, service, equipment, or material to a work of improvement on property with an existing single family, owner-occupied dwelling pursuant to a contract entered into on or after January 1, 2001, with an original contractor, or any of the original contractor's subcontractors or sub-subcontractors, who has recorded a lien, to file a statement of claim with the Contractors' State License Board. The claimant would be entitled to foreclose the lien upon a finding by a hearing officer that the owner has not paid the original contractor in full, as specified, or the owner has not complied with specified conditions, including a requirement that the owner prepare an affidavit, under penalty of perjury, that the original contractor was paid in full. Upon a determination that the owner paid the original contractor in full, the hearing officer would enter an order directing specified payment of the claimant from the Contractor Default Recovery Fund, which would be established by the bill and be continuously appropriated to provide monetary relief to any claimant who is not paid in full for this labor, service equipment, or material, and as specified.

The bill would require the Contractor's State License Board to, among other things, administer the fund and charge an annual fee of $200 to contractors who are certified home improvement contractors for deposit into the fund. The bill would provide that a finding that the original contractor was paid in full and failed to make timely payments is grounds for immediate suspension of the contractor's license. The bill would require county recorders to make available a form for the above-described affidavit.

By creating a new crime by expanding the definition of perjury and imposing additional duties upon local officials, this bill would impose a state-mandated local program.

The California Constitution requires the state to reimburse local agencies and school districts for certain costs mandated by the state. Statutory provisions establish procedures for making that reimbursement, including the creation of a State Mandates Claims Fund to pay the costs of mandates that do not exceed $1,000,000 statewide and other procedures for claims whose statewide costs exceed $1,000,000.

This bill would provide that with regard to certain mandates no reimbursement is required by this act for a specified reason.

With regard to any other mandates, this bill would provide that, if the Commission on State Mandates determines that the bill contains costs so mandated by the state, reimbursement for those costs shall be made pursuant to the statutory provisions noted above.

Vote: majority. Appropriation: yes. Fiscal committee: yes. State-mandated local program: yes.

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

SECTION 1. Article 8 (commencing with Section 3155) is added to Chapter 2 of Title 15 of Part 4 of Division 3 of the Civil Code, to read:

Article 8. Home Improvement Lien Protection Fund

3155. This article shall be known and may be cited as the Homeowners Protection Act of 2000.

3155.1. For purposes of this article, the following definitions shall apply:

(a) ‘‘Board’’ means the Contractors’ State License Board.

(b) ‘‘Claimant’’ means a person, other than an original contractor, who provides labor, service, equipment, or material to a work of improvement on property with an existing single-family owner-occupied dwelling pursuant to a contract entered into on or after January 1, 2001, with an original contractor, or any of the original contractor’s subcontractors or subcontractors, and who records a lien upon that real property for the reasonable value of labor, services, equipment, or material provided or supplied to the property.

(c) ‘‘Full payment’’ and ‘‘paid-in-full’’ means that the person who provided his or her labor, services, equipment, or material has received compensation for that labor, service, equipment, or material in an amount equal to the reasonable value of that labor, service, equipment, or material. A person shall not be considered to have been paid in full if 10 percent or more of any retention proceeds have been withheld.

(d) ‘‘Fund’’ means the Contractor Default Recovery Fund.

(e) ‘‘Original contractor’’ is a person who has a direct contractual relationship with the owner of an existing single-family, owner-occupied dwelling to provide labor, services, equipment, or material toward a work of improvement on that property.

(f) ‘‘Owner’’ is a person who is the record owner of a single-family dwelling that is his or her primary residence.

3155.2. (a) A claimant shall not be entitled to maintain an action to foreclose a recorded lien against the property pursuant to any other provision of law unless a hearing officer determines that the owner has not paid the original contractor in full in a hearing held pursuant to this article or the owner has not complied with subdivision (b).

(b) In order for an owner to receive the protection of this article against foreclosure on a lien, the owner shall do all of the following:

(1) Hire only licensed original contractors pursuant to a written contract.

(2) Prepare an affidavit, under penalty of perjury, that the owner has paid the original contractor in full.

(3) Record the affidavit within 30 days of receiving a notice of lien from the claimant pursuant to Section 3097.

(4) Serve the affidavit upon the claimant.

3155.3. (a) There is hereby established within the State Treasury the Contractor Default Recovery Fund, which is hereby continuously appropriated for the purpose of administering this article, including paying the compensation of hearing officers appointed pursuant to Section 3155.13, and providing monetary relief to any claimant who is not paid in full for labor, services, equipment, or material.

(b) Notwithstanding any other provision, payments from the fund to satisfy claims against it shall not exceed:

(1) Seventy-five thousand dollars ($75,000) per single-family, owner-occupied residence for all claims brought against that property.

(2) Five hundred thousand dollars ($500,000) per claimant over the claimant's lifetime.

(c) If claims against the fund exceed the limit in paragraph (1) of subdivision (b), the seventy-five thousand dollars ($75,000) shall be awarded proportionately so that each claimant who is awarded compensation from the fund shall receive an identical percentage.

(d) The state shall not be liable for any claims against the fund except as provided in this article.

3155.4. In order to establish a claim from the Contractor Default Recovery Fund, a claimant shall provide evidence that he or she has recorded a lien pursuant to this chapter.

3155.5. (a) The Contractors' State License Board shall administer the Contractor Default Recovery Fund

and shall develop rules and regulations to administer the fund pursuant to this article.

(b) The board may file a civil action against any licensed original contractor in order to obtain reimbursement to the fund for any payments made to a claimant upon a finding by a hearing officer that the original contractor failed to pay the claimant in full.

3155.6. (a) The Contractors' State License Board shall charge an annual fee of two hundred dollars ($200) to contractors who are certified as home improvement contractors by the Contractors' State License Board under subdivision (c) of Section 7150.2 of the Business and Professions Code. All proceeds of this fee shall be deposited in the Contractor Default Recovery Fund for the purposes of this article.

(b) The board shall annually determine whether the fees collected are sufficient to meet the projected claims over the next year and annually report to the Legislature on the need to increase or decrease fees accordingly. In making this determination, the board shall not include in any fund balance moneys in the fund that are encumbered by claims approved pursuant to this article.

(c) The board shall be responsible for an annual review or audit of the fund.

3155.7. Notwithstanding any other provision of law, the time for a claimant to bring an action to foreclose a lien shall be extended to, and include, 60 days following service of the decision by a hearing officer regarding the claimant's claim against the Contractor Default Recovery Fund.

3155.8. Within 90 days after the claimant has recorded a lien on a single-family owner-occupied dwelling which is the primary residence of the owner, the claimant shall file with the Contractors' State License Board a statement of claim. This statement of claim shall include, but may not be limited to, the following:

(a) A copy of the claimant's subcontract, purchase order, invoices, delivery tickets, credit application, or other documentation reflecting the claimant's

contractual relationship to supply labor, service, equipment, or material for the work of improvement.

(b) A copy of any preliminary notice given by the claimant, together with the proof of service accompanied thereby, if a claimant is otherwise required to serve a preliminary notice.

(c) A copy of the mechanic's lien recorded in the office of the county recorder.

(d) A statement of account showing all charges, credits, and balance due.

(e) Proof of service of the appropriate documents described in subdivisions (a) to (d), inclusive, to both the original contractor and the owner.

3155.9. Once the statement of claim described in Section 3155.8 has been filed with the Contractors' State License Board, the board shall notify the original contractor and the owner of the filing of the claim. The original contractor and the owner shall file a response within 15 days after receipt of the notice. This response shall state in detail the defense against the claim and include all documents which the respondent claims support this defense. If the original contractor contends that it has not been paid in full, the original contractor shall provide a copy of all documents in support of this contention. The claimant, original contractor, and owner shall submit any other information to assist the hearing officer to make the determinations required by this article.

3155.10. If the original contractor fails to respond to the claim filed by the claimant, the hearing officer shall find that the owner paid the contractor in full and then determine the value of the claim based upon the documentation provided.

3155.11. The board shall set a hearing date within 60 days of receipt of the statement of claim at the office of the Contractors' State License Board nearest to the site of the work of improvement before a hearing officer appointed by the board pursuant to Section 3155.13 to hear the presentations of the claimant, the original contractor, and the owner. To the extent possible, all

claims submitted on the same project shall be consolidated and heard in the same hearing. The Contractors' State License Board shall provide notice to the original contractor, the owner, and the claimant of the date, time, and location of this hearing.

3155.12. At the hearing, the hearing officer shall first determine whether the owner has made a full payment to the original contractor. If the hearing officer determines that the owner has not paid the contractor in full, the hearing officer shall dismiss the claim and issue a finding that the claimant may pursue foreclosure of its mechanic's lien in the appropriate court. If the hearing officer determines that the owner has paid the original contractor in full, the hearing officer shall determine the validity and reasonable value of the claim and, if determined to be valid, enter an order addressed to the Contractors' State License Board directing it to pay the claimant the amount of the claim, subject to subdivision (b) of Section 3155.3.

3155.13. (a) The hearing shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

(b) The hearing officers appointed by the Contractors' State License Board shall be attorneys licensed to practice in this state with at least five years of experience in mechanic's lien law.

3155.14. (a) The findings of the hearing officer shall be final and impose obligations upon the owner, original contractor, and claimant only to the extent that the owner, original contractor, or claimant agree to be bound by those obligations. However, the remedies available to a party pursuant to this article, including the right to receive payment from the fund, shall not be available to a party that does not agree to the obligations. A claimant shall be deemed to agree to the obligations only by recording a release of the lien in the county recorder's office where the real property is located. The findings of the hearing officer may be entered into evidence in any subsequent civil action or proceeding. The findings of the

hearing officer shall be served on the claimant, original contractor, the owner, and the board no more than 10 days after the hearing.

(b) The Contractors' State License Board shall pay to the claimant, upon receipt of an order pursuant to Section 3155.12, the amount of the claim, subject to subdivision (b) of Section 3155.3, within 10 days of receiving evidence that the claimant has recorded a release of its lien in the county recorder's office where the real property is located. This evidence shall be submitted within 15 days after findings of the hearing officer are served.

3155.15. A finding by the hearing officer that the original contractor was paid in full by the owner and failed to make timely payments to any claimant on the work of improvement, except a finding made pursuant to Section 3155.10, shall be grounds for immediate suspension of the original contractor's license. The original contractor shall be given notice of a hearing to challenge the finding, which shall be conducted within 60 days of the date of the suspension, pursuant to the procedures of the Contractors' State License Board. If the finding is sustained, the contractor's license shall be immediately revoked and shall not be reinstated until the original contractor can supply to the Contractors' State License Board a contractor's license bond as provided in Section 7071.8 of the Business and Professions Code in the sum of fifty thousand dollars ($50,000).

3155.16. The county recorder shall make available forms for the affidavit described in Section 3155.2 and a notice regarding the owner's rights under this article. The Judicial Council shall adopt forms for the affidavit and the notice.

SEC. 2. No reimbursement is required by this act pursuant to Section 6 of Article XIII B of the California Constitution for certain costs that may be incurred by a local agency or school district because in that regard this act creates a new crime or infraction, eliminates a crime or infraction, or changes the penalty for a crime or infraction, within the meaning of Section 17556 of the Government Code, or changes the definition of a crime

within the meaning of Section 6 of Article XIII B of the California Constitution.

However, notwithstanding Section 17610 of the Government Code, if the Commission on State Mandates determines that this act contains other costs mandated by the state, reimbursement to local agencies and school districts for those costs shall be made pursuant to Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code. If the statewide cost of the claim for reimbursement does not exceed one million dollars ($1,000,000), reimbursement shall be made from the State Mandates Claims Fund.

O

UNIFORM CONSTRUCTION LIEN ACT

PREFATORY NOTE

This Act is based almost entirely upon Article 5 (Construction Liens) of the Uniform Simplification of Land Transfers Act. That Act was promulgated by the National Conference of Commissioners on Uniform State Laws in 1976 and amended in 1977. In 1985, the Conference appointed a drafting committee to draft a free standing construction lien act based on the 1977 Act. The decision to prepare a free standing act rested on the assumption that many states might be interested in adopting a modern uniform mechanics' lien act but would not be interested in some other aspects of the Uniform Simplification of Land Transfers Act which deals with such things as prerequisites for recording in the land records, general priorities among purchasers of land, and so on. In fact, in 1981, Nebraska had extracted the Construction Lien Article from USLTA and adopted that Article as a free standing Act. (R. Rev. Stat. Neb. Section 52-125ff. 1984).

The Construction Lien Drafting Committee, in consultation with the Joint Editorial Board of the Uniform Real Property Acts and with various other interested parties, prepared the present Act. The Joint Editorial Board is composed of members of the National Conference, the American Bar Association, and the American College of Real Estate Lawyers. It has jurisdiction over a number of Conference Acts dealing with real estate matters, including the Uniform Condominium Act, the Uniform Planned Community Act, the Uniform Common Interest Ownership Act, the Uniform Land Transfer Act, the Uniform Simplification of Land Transfers Act, and the Uniform Land Security Interest Act.

While the present Act, as noted, is essentially the same as Part 5 of the Uniform Simplification of Land Transfers Act, there are some significant changes. The most significant change is the addition in this Act of trust fund provisions which create a trust of which construction lien claimants are beneficiaries in certain funds of owners and contractors. Those provisions are contained in Section 501 of the Act and will be further discussed at the end of this prefatory note.

All states presently have mechanics' lien laws. Those laws present an extraordinarily varied approach, in substance, and in language, to the issues involved in mechanics' lien legislation. In fact, variation among the states may be greater in this area than in any other statutory area. In an era of national lenders and suppliers and of many multistate builders, the variation among the states as to mechanics' lien matters is a substantial impediment to an efficient mortgage and real estate market. Furthermore, the present priority and owner liability rules present difficult problems for contractors, owners, lenders, and courts, and add

substantial expense and risk to many real estate transactions. Therefore, significant benefit could be gained from the widespread adoption of a uniform mechanics' lien act.

This Act is, it will be noted, titled "Uniform Construction Lien Act." This title, suggested by a Wisconsin modification of its mechanics' lien laws, is adopted because the title "Mechanics' Liens" improperly implies that laborers are the primary beneficiaries of mechanics' lien laws. With the payment of wages weekly or bi-weekly by contractors (as is the universal custom today) wage claimants no longer loom large in mechanics' lien situations.

The basic structure of this Act and its predecessor owes much to the Florida mechanics' lien law which was adopted in 1963. For example, the dating of the lien claimant's priority from the time of recording a "notice of commencement" covering the construction project is a feature of the Florida legislation.

While there is great diversity in mechanics' lien laws, they deal with common issues, and tend to fall into a limited number of patterns on each of the major issues involved. These major issues are listed below and will be considered in this introductory note: (1) who may secure a construction lien; (2) is the owner protected in making payments to the prime contractor if, at the time he pays, he has no notice of a construction lien claimant below the prime; and (3) from what time does the mechanics' lien take priority over third party buyers, mortgagees, or levying creditors who deal with the real estate.

Who May Secure a Lien?

Mechanics' lien statutes give liens against the real estate being improved to persons who supply services (including labor) and materials for the improvement. In about half the states, any person who supplies services or materials is allowed a lien, no matter how far removed he is from the owner. Other states limit those who can secure a lien to two tiers (prime contractor, subcontractor), three tiers (prime contractor, subcontractor, sub-subcontractor) or four tiers. A few others allow a lien to two tiers plus all materialmen and laborers, and one gives a lien to all who contract with licensed contractors. In this Act, liens are allowed to any person who furnishes services or materials pursuant to a real estate improvement contract, no matter how far removed he is from the contracting owner.

This Act follows many present mechanics' lien laws in allowing a lien to suppliers of materials only when they have in some way indicated that they sell with the belief that the materials are to be used on the particular real estate improvement project. Therefore, a supplier who delivers materials to a contractor

without knowing the particular real estate on which the materials are to be used cannot later claim a lien on the real estate on which the materials were actually used. Most present acts give a lien to a materialman only if the materials are delivered to the site. This Act relaxes that requirement somewhat and allows a lien if seller's belief that the goods are to be used on a particular site is evidenced either by a notation on the sales contract, by a delivery order, or by actual delivery to the site.

However, except with respect to materials specially fabricated for the particular real estate and not salable in the ordinary course of the materialman's business, a materialman gets no lien unless the materials are actually used in the making of the improvement. A lien is given to persons who supply materials such as gasoline, which are consumed in the course of the improvement, and also to lessors of machinery and tools used in making the improvement.

Preparation of plans, surveys, and architectural or engineering plans are improvement contracts for which a lien is allowed. Therefore, surveyors, architects, engineers and others who prepare such surveys and plans are allowed liens on the real estate involved whether or not the planned improvement is actually made.

Priority Over Third Parties

Most mechanics' lien laws date the lien claimant's priority over third parties from the time of "commencement" or "visible commencement" (hereafter both statements of the rule are referred to by the use of the word "commencement") of the improvement, provided that the claimant records his lien within a limited period of time after he completes his work on the project. A commencement priority rule makes it difficult for persons who deal with real estate to determine whether it may be subject to subsequently asserted lien claims since a record title examination will not provide the necessary information. That priority rule, in effect, gives the lien claimant a secret lien. The secret lien is of limited duration since all statutes require the claimant to record a notice of lien within a fairly short period of time (2 to 18 or so months after completion) if he is to realize on the lien. Nevertheless, the title difficulties created are substantial.

A commencement priority rule also creates particular difficulties for construction lenders. Such lenders usually record their mortgage at about the time the work is beginning, and, with some regularity, a construction lender discovers that work had commenced prior to the time he recorded so that he is junior to the construction lien claimant. Under the commencement priority rule, careful construction lenders make on-site inspections prior to recording their mortgage and

make efforts to preserve evidence that no work had commenced when they recorded. Such efforts involve additional expense and do not guarantee that a court will later agree that recording by the mortgagee predated commencement.

A number of states, in response to the problems created by the commencement priority rule, have fixed other mechanics lien priority dates. A few states date mechanics' lien priority from the time of recording the individual claimant's lien. This system protects the integrity of the real estate records, but prevents a contractor or materialman who furnishes services or materials late in the construction from getting priority equal with that of those who furnish services or materials early. Illinois makes the time the owner and a prime contractor enter into the improvement contract the priority date for that prime and claimants who claim through him. A few states date all claimants' priority from the time the prime contract or a notice thereof is recorded in the real estate records. That system, also, protects the integrity of the public records, but, like the Illinois system, gives claimants under different primes different priorities in cases in which the owner uses more than one prime contractor on an improvement project.

This Act adopts a notice recording device, first developed in Florida, under which the owner, prior to the beginning of work on an improvement, records a "notice of commencement" which puts third parties on notice that construction liens may be claimed against the real estate. If a lien claimant records his lien during the effective period of a notice of commencement, his priority date is the date the notice of commencement was recorded.

The notice of commencement, somewhat like a Commercial Code Article 9 financing statement, need not contain any details concerning the proposed improvement and, if not limited by its terms, protects any person who furnishes materials or services to improve the real estate described in the notice of commencement, whether or not the improvement made was within the contemplation of the owner at the time the notice of commencement was recorded.

The notice of commencement is effective for the time stated therein (but at least six months), or, if no time is stated, for three years, except that the notice is effective for only one year as against a protected party buyer of residential real estate. The owner may, however, terminate the notice of commencement before its expiration date by recording a notice of termination, publishing a copy of the notice, and notifying claimants who have requested notice of a termination. If an owner terminates a notice of commencement, except in connection with stoppage or completion of the work, he is personally liable to construction lien claimants to the extent that his termination prevents realization on a lien.

If a notice of commencement is not recorded, lien claimants take priority from visible commencement of the improvement. There are, however, two exceptions to the visible commencement rule. First, after a notice of commencement is recorded, even though recorded after visible commencement of the improvement, the priority date is the time the notice of commencement is recorded. Second, if a notice of commencement has expired, a claimant cannot get a priority date earlier than the date his lien is recorded, or 30 days after expiration of the notice of commencement, whichever is earlier. If a notice of commencement has not been recorded, a claimant, rather than relying on the rules just stated, may record a notice of commencement which fixes the priority date in the same way that an owner's notice of commencement does.

The notice of commencement system permits third parties to rely on the record and, at the same time, gives all claimants on a particular improvement equal priority no matter how many prime contractors there are and no matter when the particular claimant comes on the job. In cases where construction has taken place without recording of a notice of commencement, a prospective lender or buyer can clear up the situation by having the owner record a notice of commencement and immediately thereafter record a notice of termination. Under the notice of termination procedure, the notice of commencement can be terminated 30 days after it was recorded, but as indicated above, public advertisement is necessary. Therefore, prospective lien claimants are put on notice that they must act promptly to preserve their liens. In that case, lien claimants must come in and record their liens before termination or be deferred to the time they actually record or 30 days after the termination date, whichever is earlier.

Particularly in smaller, owner-financed improvements, it may be uneconomical to record a notice of commencement, and, in such cases, as already noted, claimants are protected by giving them a visible commencement priority date.

This Act follows practically all prior mechanics' lien laws in denying priority over prior mortgages to the construction lien. A few states give the lien priority over the prior mortgage to the extent of the value added to the real estate by the improvement and a few states provide that under the lien the improvement can be sold and removed from the real estate.

Is The Owner Protected In Making Payments To The Prime Contractor, If, At The Time He Pays, He Has No Notice That A Mechanics' Lien Claimant Claiming Under The Prime Has Not Been Paid?

In many states, under present law, an owner cannot with safety pay a prime contractor even though no claimant claiming through that prime contractor has made a demand that he be paid directly by the owner. In those states, the owner takes the risk that a prime contractor or others in the contracting chain will not apply payments received by them to the payment of suppliers of services and materials which will have a lien on the improvement. Possible owner double liability leads, in those states, to elaborate lien waiver or direct disbursement techniques where knowledgeable parties are involved. In other states, the owner is protected so long as he in good faith pays a prime contractor before any demand is made upon the owner for payment by a potential lien claimant.

This Act offers the states two alternatives which continue the two existing patterns. Under the first alternative, an owner's real estate is subject to the liens of claimants below a prime contractor only to the extent that the owner has not paid the prime contractor at the time he receives notice from the claimant of the prospective lien claim. Under the second alternative, a claimant below a prime contractor can assure himself of a lien against the owner for his full contract price by notifying the owner within 20 days after the claimant first furnishes services or materials. If the claimant so notifies the owner, the owner cannot defend that he had already paid the prime contractor at the time he received the notice. The 20-day notice requirement, patterned after the California lien law, however, does give the owner substantial protection against double payment.

If a state wishes to adopt the first alternative, it should enact Alternative A of Section 207. If it wishes to adopt the second alternative, it should enact Alternative B of that section. See the additional comments preceding Section 207, Alternative B.

As noted above, this Act imposes a trust for the benefit of prospective lien claimants in certain assets of owners and contractors. A number of states presently have trust fund provisions similar to those adopted in this Act. The effect of the trust fund provisions are to impose liability for breach of trust on an owner or contractor who fails to use trust assets to pay lien claimants. Such liability would ordinarily include criminal liability and individual liability for agents of the owner or contractor who participate in the breach of trust. The existence of a trust also means that third parties who claim an interest in the trust assets will lose to the beneficiaries unless they would prevail against beneficiaries under trust law. Therefore, for example, most takers of security interests in a contractor's accounts

receivable would lose to lien claimants who are beneficiaries of the trust created by this Act in the receivables.

Trust assets in the case of an owner are money lent to him under a construction mortgage, and proceeds of sales or mortgages made during the construction or thereafter during the period during which a lien could be filed against the property. In the case of contractors, trust assets are the payments and right to be paid under the contract in question.

The Act permits the trustee of the trust to treat himself as a beneficiary of the trust and also permits the trustee to pay trust claims in any order he chooses. It further permits use of trust assets for non-trust purposes, so long as trust assets remaining are sufficient to pay all claims which arise or which are reasonably likely to arise in the future. Those provisions significantly ameliorate the impact of the trust fund rules on the trustee.