Study H-820 April 10, 2000

First Supplement to Memorandum 2000-26

Mechanic's Liens (Comments of Gordon Hunt)

Attached to this supplement are comments from Gordon Hunt on the *Mechanics Lien Law Comments*, prepared by Keith Honda, Chief of Staff, Office of Assemblyman Mike Honda (Feb. 10, 2000), which were distributed at the February meeting, and attached to the Second Supplement to Memorandum 2000-9.

Mr. Hunt gives his analysis of the constitutional limitations on statutory revisions of the mechanic's lien law. Mr. Hunt submitted several attachments with his comments, which have not been reproduced to save copying costs (a reference copy will be available at the meeting):

1. Roystone Co. v. Darling, 171 Cal. 526 (1915).
2. Wm. R. Clarke Corp. v. Safeco Ins. Co, 15 Cal. 4th 882, 64 Cal. Rptr., 2d 578, 938 P.2d 372 (1997).
3. G. Hunt & K.C. Gibbs, California Construction Law 297-309, 417-37 (16th ed.).
4. Hunt, *California Mechanics' Lien Law: Need for Improvement*, 9 Santa Clara Law. 101 (1968).

Mr. Hunt concludes by renewing his recommendation to consider a mandatory payment bond if the Commission concludes that problems concerning smaller private construction projects need special treatment.

As to the constitutional issues, the staff has not attempted to come to any conclusion in the abstract. Depending on the direction the Commission decides to take, we will attempt to address questions of constitutionality later in the project. While it is impractical to amend the Constitution, it can be done, and at this stage the Commission should not refuse consideration of an otherwise desirable proposal solely on the grounds that it may be or is likely to raise constitutional issues.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

COMMENTS BY GORDON HUNT UPON THE
FEBRUARY 10, 2000 MEMORANDUM
SUBMITTED BY ASSEMBLY MEMBER MIKE HONDA

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I. INTRODUCTION

At the meeting of the Law Revision Commission held on Friday, February 10, 2000, Keith Honda, on behalf of Assembly Member Mike Honda, presented his "Mechanic's Lien Law Comments" dated February 10, 2000. The gist of said Memorandum was that the Legislature could enact a statute that would eliminate the Mechanic's Lien rights on a single family owner-occupied dwelling where the owner had paid the contractor in full and that such a statute would be constitutional. For the reasons hereinafter set forth, such a statute would be unconstitutional.

II. A STATUTE ELIMINATING THE RIGHT TO A MECHANIC'S LIEN ON A HOME IMPROVEMENT PROJECT WOULD BE UNCONSTITUTIONAL

Anyone familiar with the history of the Mechanic's Lien Law and cases that have interpreted it would clearly understand that the constitutionality guaranteed right of a Mechanic's Lien cannot be eliminated by statute, and that such a statute would be unconstitutional.

The history of the Mechanic's Lien Law has previously been commented upon in Part 1 and Part 2 of your consultant's reports. The early history of the California Mechanic's Lien Law leading up to the enactments of 1911 were carefully analyzed in the Supreme Court case of Roystone v. Darling, 171 Cal.526 (1915). The case was summarized on

Pages 7, 8 and 9 of Part 2 of the report of your consultant. A copy of the opinion is attached hereto as an exhibit. In summary, the opinion makes it clear that the Legislature has balanced the interests of the owner and the lien claimants by limiting the owner's liability for Mechanic's Liens to its contract price where the owner has obtained a payment bond for 50% of the contract price and recorded it in the County Recorder's Office. As noted by the California Supreme Court in the Roystone case (at Page 531), the Mechanic's Lien Law declared that every person performing labor or furnishing materials to be used in the construction of any building should have a lien upon the same for such work or material and that said provision of the lien law did not limit liens to the contract price. When the Constitution of 1879 was adopted, it provided exactly as it provides today, to-wit:

> "Mechanics, materialmen, 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 enactment of the lien law in 1911, adding the bonding provision, protected the owner and eliminated lien rights where the owner had bonded the project and where the owner had paid the contractor in full. Justice Henshaw, in his concurring opinion, stated the following at Page 544:

> "It would seem when the Constitution of this state declares, as it does, that 'mechanics, materialmen, artisans, and laborers of every class shall have a lien upon the property...for the value of such labor done or material furnished,' that is wholly beyond the power of the Legislature to destroy or even impair this lien."

In the case of Hammond Lumber Co. v. Moore, 104 Cal.App. 528 (1930), the court stated the following at Page 532:

> "The right of mechanics, materialmen, etc., to a lien upon property upon which they have bestowed labor, or in the improvement of which materials which they have furnished have been used, for the value of such labor or materials, is guaranteed by the Constitution, the mode and manner of the enforcement of such right being committed to the legislature. (Art. XX, see 15, Const.) Manifestly, the legislature is not thus vested with arbitrary power or discretion in attending to this business. Indeed, rather than power so vested in the legislature, it is a command addressed by the Constitution to the law-making body to establish a reasonably framed system for enforcing the right which the organic law itself vouchsafes to classes named. Clearly, it is not within the right or province of the legislature, by a cumbersome or ultra-technical scheme designed for the enforcement of the right of lien, to impair that right or unduly hamper its exercise. Every provision of the law which the legislature may enact for

> the enforcement of the liens mentioned in section 15 of article XX of the Constitution must be subordinate to and in consonance with that constitutional provision."

The case of Martin v. Becker, 169 Cal. 301 at Page 316 states that "...the lien of the mechanic in this state...is a lien of the highest possible dignity, since it is secured not by legislative enactment but by the Constitution of the state...grave reasons indeed must be shown in every case to justify a holding that such a lien is lost or destroyed."

In the case of Hammond Lbr. Co. v. Barth Invest. Corp., 202 Cal. 606 at 610, the California Supreme Court stated:

> "In fact, liens of mechanics and materialmen are protected by section 15, article XX of the state constitution. The right to assert such a lien is remedial in its character and should be liberally construed in its entirety with a view to effect its objects and to promote justice. (Continental Building & Loan Assn. v. Hutton, 144 Cal. 609 [78 Pac.21]. McClung v. Paradise, etc. Co., 164 Cal. 517 [129 Pac.774]; Martin v. Becker, 169 Cal. 301 [Ann. Cas. 1916D, 171, 146 Pac. 665].) The function of the legislature is to provide a system through which the right of mechanics and materialmen may be carried into effect, and this right cannot be destroyed or defeated either by the legislature or courts, unless grave reasons be shown therefor. (Martin v. Becker, supra; Hughes Bros. v. Hoover, 3 Cal.App. 145 [84 Pac.681].)"

The California Supreme Court, in the case of English v. Olympic Auditorium, Inc., 217 Cal. 631 at Pages 640, 641 and 642 states the following:

> "Should the lien laws be so interpreted as to destroy the liens because the leasehold interest has ceased to exist, such interpretation, would render such laws unconstitutional. (Sec. 15, art. XX, Cal.Const.)
>
> There can be no doubt that the equities are with the plaintiffs. They have put into the building, in labor and material, many thousands of dollars for which they have not been paid and the building has cost the respondents nothing whatever. To turn it over to the defendants freed from the liens of plaintiffs would be grossly inequitable. While equity follows the law, we do not believe that it is necessary to give a strained construction to the law so that this costly structure may be given to the defendants without any return to the men who created it.
>
> As said in Stimson Mill Co. v. Nolan, 5 Cal.App. 754, 760 [91 Pac. 262, 264], in speaking of mechanic's liens, 'The right to declare such a lien is based upon the theory that the materialman and laborer produce the thing upon which the lien is declared.' In Jones v. Great Southern Fireproof Hotel Co., 86 Fed. 370, 385, it is said by the court, in relation to statues creating similar rights of lien: 'But the validity of such statues need not be rested upon mere authority. They find sanction in the dictates of natural justice, and most often and administer an equity which has

> recognition under every system of law. That principle is that everyone who, by his labor or materials, has contributed to the preservation or enhancement of the property of another, thereby acquired a right to compensation.' Similar expressions are found in many cases and are applicable to the facts of this case."

In the case of Young v. Shriver, 56 Cal.App. 653 at Pages 655 and 656, the court stated the following:

> "The counsel for the respondents declare, in one of their briefs, that the right of mechanics, materialmen, artisans, and laborers of every class to a lien upon property upon which they have bestowed labor or for which they have furnished materials of for the value of such labor done and materials furnished, is strictly statutory. This is not altogether true. The source of that right is in our organic law. (Const., art XX, sec. 15.) By that provision of the constitution the legislature is enjoined to provide by law 'for the speedy and efficient enforcement of such liens.' Of course, the right to compensation for such labor and materials arises out of contract and the constitution merely selects such classes of contracts as those for the enforcement of which an equitable remedy may be invoked. When the legislature established the means or procedure whereby the remedy vouchsafed in such cases by the constitution might be brought into action, it did all that it was authorized to do by the constitution and we presume that no one will say that the right to the remedy expressly authorized by the organic law can be frittered away by any legislative action or enactment."

More modern cases have continued the foregoing propositions. In that connection, the Commission's attention is directed to Pages 1, 2 and 3 of Part 1 of report of this consultant and specifically the cases cited in the footnotes on Pages 2 and 3 of Part 1 of this consultant's report.

The decision of the California Supreme Court, in the case of Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal.4th 882 (1997), particularly illustrates what the California Supreme Court has said about Mechanic's Liens. In that particular case, a prime contractor had in its subcontract a "pay-if-paid" provision which was standard practice of general contractors at that time. The paid-if-paid provision makes payment by the owner to the general contractor a condition precedent to the general contractor's obligation to pay the subcontractor for work the subcontractor has performed. A copy of the Clarke opinion is attached hereto. The pay-if-paid provision that was in the subcontract is described on Pages 898 and 899 of the opinion. It is, of course, a clear contractual provision agreed to by the subcontractors that provides that the subcontractors cannot recover from the contractor unless or until the contractor has been paid by the owner. The California Supreme Court held that provision unenforceable. The Supreme Court noted on Pages 888 and 889 the following:

> "Our state Constitution provides: 'Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien 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 lien'. (Cal.Const., art XIV, §3.) As this court has said, '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 [253 Cal.Rptr. 236, 763 P.2d 1326].) '[S]tate policy strongly supports the preservation of laws which give the laborer and materialmen security for their claims.' (Connolly Development, Inc. v. Superior Court (1976) 17 Cal.3d 803, 827 [132 Cal.Rptr. 447, 553 P.2d 637].)"

The Supreme Court then noted that a Mechanic's Lien claimant could only wave its lien rights pursuant to Civil Code §3262. The Supreme Court concluded as follows:

> "We granted review in this case to determine whether a subcontractor may collect on a general contractor's payment bond for work it has performed under a contract containing a pay if paid provision when the owner has not paid the general contractor. We conclude that pay if paid provisions like the one at issue here are contrary to the public policy of this state and therefore unenforceable because they effect an impermissible indirect waiver or forfeiture of the subcontractors' constitutionally protected mechanic's lien rights in the event of nonpayment by the owner. Because they are unenforceable, pay if paid provisions in construction subcontracts do not insulate either general contractors or their payment bond sureties from their contractual obligations to pay subcontractors for work performed."

It is clear by a review of the foregoing cases that the courts in California have clearly held that the lien right is sacrosanct under the Constitution. The Legislature may enact provisions for enforcement, but any statute seeking to abolish the right guaranteed by the California Constitution would be unconstitutional. This was clearly the opinion of the Legislative Counsel of California as set forth in their letter of May 11, 1999, attached as an exhibit to the comments of Keith Honda. Specifically, Legislative Counsel rendered the following opinion:

> "A statute that provides the owner of residential real property who pays a contractor in full for a work of improvement on the property with a defense against a mechanics' lien filed by a subcontractor who has bestowed labor on, or furnished material for, that work of improvement would be unconstitutional."

III. THE NOTICE OF NON-RESPONSIBILITY SECTIONS OF THE CIVIL CODE AND THE PRIORITY SECTIONS OF THE CIVIL CODE DO NOT ELIMINATE THE LIEN RIGHT, BUT MERELY BALANCES THE INTERESTS OF THE LIEN CLAIMANTS VERSUS THOSE OF A NON-CONTRACTING OWNER AND A CONSTRUCTION LENDER

Mr. Honda's report suggests that there are various things that can result in a loss of the lien right to lien claimants. That is correct. The Legislature is empowered to set up the conditions pursuant to which the Mechanic's Lien can be enforced, that is, the procedural steps that the claimant must take in order to enforce its lien right. However, none of the statutes eliminate the lien right. The comments by Mr. Honda also ignore the history of the lien law as previously articulated herein and in Parts 1 and 2 of the reports of the undersigned.

Mr. Honda refers to Section 3094 of the Civil Code which provides a defense to the Mechanic's Lien for homeowners who post and record a Notice of Non-Responsibility. This is merely an example of the Legislature's continuing attempt to balance the interests of the lien claimants which are guaranteed by the Constitution versus the interests of a "non-contracting owner". The Notice of Non-Responsibility Law only comes into play when someone other than the owner of the fee interest in the property is causing the improvements to be done, such as a tenant. Under those circumstances, the Legislature has balanced the interests of the "non- contracting owner" versus those of the lien claimant and provided a means and method pursuant to which the non-contracting owner can protect his or her fee interest in the property from Mechanic's Liens. As noted above, the courts have addressed this issue and have concluded that where the owner has properly posted and recorded a Notice of Non-Responsibility, the lien is upon the structure down to the surface of the ground. The lien right itself is not lost and as noted supra, the English v. Olympic Auditorium case has stated that any law attempting to eliminate the lien right in its entirety would be unconstitutional. The Notice of Non-Responsibility Statute and the cases interpreting same have been fully explained by your consultant in *California Construction Law,* 16th Edition, 2000 in Section 9.01(a)(6). A copy of Pages 297-300 of *California Construction Law,* co-authored by your consultant and Kenneth C. Gibbs is attached hereto. It is clear by the statute and the case law interpreting same that the lien right is not lost, it is merely limited to the structure down to the surface of the ground and the leasehold interest of the tenant. A statute eliminating the lien right would, as noted supra, be held to be unconstitutional.

The Honda memorandum then refers to the fact that the statute eliminating the lien right on public works of improvement is an example of a statute that impairs the lien right. On the contrary, that is again the Legislature's way of balancing the interests of the public and the tax payers versus those who improve public property. The Legislature, recognizing that it would be impractical to allow Mechanic's Liens on public property, has instead substituted the mandatory payment bond on public works of improvement. The rights which the Legislature has granted to persons who improve public property is fully explained in Chapter 10 of *California Construction Law*, Pages 417-437. A copy of that chapter is attached hereto. Obviously, what the Legislature has done is to provide the lien claimants with two alternative sources of recovery, to-wit, a Stop Notice and the right to recover on a payment bond that is required on all public works of improvement.

The Honda memorandum then, through its attachments, gives as further examples the fact that the Legislature has prohibited unlicensed contractors from enforcing Mechanic's Liens. That, of course, is a different public policy which is clearly defined and discussed fully in Chapter 1 of *California Construction Law*. That public policy is evidenced in the Business & Professions Code which provides, in effect, under Section 7031 that any person required to be licensed under the License Law is prohibited from seeking recovery in the courts if that person is unable to plead and prove that it was duly licensed at all times during the performance of the work. The unlicensed contractor or subcontractor does not lose their lien rights because of the Mechanic's Lien Law, but by virtue of the Business & Professions Code, which enforces a strong public policy in the State of California that all contractors and subcontractors must be licensed.

The Honda memorandum also, through its exhibits, states that a beneficiary of a Deed of Trust has priority over Mechanic's Liens and therefore a lien can be lost where the owner defaults and the construction lender forecloses. Again, this statement misses the point. The lien right itself is not lost. The claimants still have the right to record a Mechanic's Lien. What the Legislature has done is to balance the interests of the banks versus those of the lien claimants. The Legislature recognizes that the banks must have a first priority position in order to make construction loans. Thus, the Mechanic's Lien Law gives the bank a priority if its Deed of Trust is recorded before work commences. Obviously, the Legislature recognized that in order to have construction financing, the banks must have priority for the Deed of Trust that secures their construction loan. In light of the fact that many liens were being wiped out by foreclosure of the prior Deed of Trust in favor of the construction lender, the Legislature enacted in 1951 the right to file a bonded Stop Notice with the construction lender by all unpaid claimants. Again, an example of balancing the interests between the claimants and those of other persons interested in the construction process, claimants have this alternative source of recovery in the event their lien right should be wiped out by foreclosure. The Stop Notice remedy is likewise fully discussed by your consultant in *California Construction Law*, Chapter 9, Section 9.01(b) on Pages 300-309. A copy of those pages is attached hereto as an exhibit.

Thus, the examples given by Mr. Honda do not apply. None of those examples eliminates the lien right, but merely balances the interests of the lien claimants versus the rights of other parties who have an interest in the property. The non-contracting owner's fee interest in the property is protected if that non-contracting owner posts and records a Notice of Non-Responsibility. It does not eliminate the lien right, it merely restricts it to the structure down to the surface of the ground and the leasehold interest of the tenant. The priority granted to construction lenders does not eliminate the lien right, but merely gives the lenders an interest that is prior to the Mechanic's Lien right if the Trust Deed is recorded before work commences. Again, the Legislature has balanced the interests of the banks versus the lien claimants. In order to give protection that the Constitution guarantees to the lien claimants in the event that a prior recorded Deed of Trust forecloses thereby wiping out the claimant's Mechanic's Lien, the Legislature has given the claimants an alternative source of recovery, to-wit, the right to file a bonded Stop Notice with the construction lender. The Legislature has wisely seen fit to protect the tax payers' interests in public improvements by providing that there are no lien rights on public works of improvement. Recognizing the constitutionally guaranteed right of lien, the Legislature has wisely chosen to protect those who improve public property by providing

viable alternative sources of recovery in the event of non-payment, to-wit, the right to file a Stop Notice with the public body and the right to bring an action on the payment bond that is required on all pubic works of improvement. Thus, the lien right is not destroyed by these provisions, but the Legislature has balanced the interests in certain circumstances.

IV. THE CREDIT RISKS OF PERSONS IN THE CONSTRUCTION INDUSTRY ARE SUBSTANTIALLY DIFFERENT THAN CREDIT RISKS IN OTHER BUSINESSES AND THEREFORE REQUIRE THE SPECIAL PROTECTION OF THE MECHANIC'S LIEN LAW

The Honda memorandum likewise suggests that the lien law is unfair where the owner has paid the contractor in full and still has lien rights filed against its property. This, of course, has been previously addressed by your consultant in Part 2 of its report and your consultant respectfully directs the Commission's attention to Part 2 of the report. In summary, the Legislature has balanced the interests of the owner versus the lien claimants by providing a means and mechanism pursuant to which the owner can protect its contract price and protect its property
from Mechanic's Liens by obtaining and recording a payment bond equal to 50% of the contract price.

The Honda memorandum further suggests that it is not proper to give the lien claimants protection because of alleged unwise extensions of credit. The memorandum in that respect fails to recognize the realities of the construction industry. The memorandum ignores the fact that the construction industry is different than other industries. This fact was not ignored and was clearly understood by the California Supreme Court in Connolly Development, Inc. v. Superior Court, 17 Cal.3d 803 (1976). Specifically, the California Supreme Court stated, at Page 827 of the opinion the following:

> "When the practice of recording a construction loan trust deed before the commencement of construction reduced the effectiveness of the mechanics' lien, the courts and the Legislature evolved alternative remedies — the equitable lien and the stop notice — which attach directly to the loan fund.
>
> This protective policy continues to serve the needs of the construction industry. As was pointed out in *Cook v. Carlson, supra*, 364 F.Supp.24, 29: 'Labor and material contractors [in the construction industry] are in a particularly vulnerable position. Their credit risks are not as diffused as those riding on one transaction, and they have more people vitally dependent upon eventual payment. They have much more to lose in the event of default. There must be some procedure for the interim protection of contractors in this situation.' Without such interim protection, the improvement may be completed, the loan funds disbursed, and the land sold before the claimant can obtain an adjudication on the merits of his claim."

Thus, the California Supreme Court recognizes that the contractors, subcontractors, material suppliers and the laborers who work on a construction project are in a particularly vulnerable position. Their credit risks are not as diffused as those of other creditors in other industries. They extend a bigger block of credit and they have more riding on one transaction than the creditors in other industries. The contractors, subcontractors, material suppliers and the laborers who work on those projects have much more to lose in the event of default. As a result, we have the Mechanic's Lien Law which protects the people who create the improvements to the owner's real property.

V. THERE ARE OTHER ALTERNATIVES THAT THE COMMISSION MAY WISH TO CONSIDER IN REVIEWING THE MECHANIC'S LIEN LAW

In 1968, there was a bill pending in the California Legislature to recodify the entire Mechanic's Lien Law. At that time, your consultant wrote a Law Review article for the Santa Clara Lawyer. A copy of that Law Review article is attached hereto. One of the suggestions of your consultant in that Law Review article was bonding of all private works of improvement. It is respectfully suggested that possibly that concept could be revised to meet the so-called "problem of double payment" in the case of a home improvement contract on a single family residence which is owner-occupied (which problem even Mr. Keith Honda concedes is not a big problem) by providing some type of a mandatory payment bond requirement on private works of improvement where the improvement is a single family owner-occupied dwelling. An example would be a "mini" performance and payment bond on such works of improvement of 50% of the contract price on improvements not exceeding some monetary limit such as $50,000.00.

VI. CONCLUSION

For the reasons hereinabove set forth, it is clear that the courts in California have recognized throughout the history of the Mechanic's Lien Law that the Mechanic's Lien is guaranteed by our Constitution and the Legislature shall provide for its "speedy and efficient" enforcement. A statute eliminating the lien right on a home improvement contract would result not in the "speedy and efficient" enforcement of that lien right but, in fact, a total and complete obliteration of that lien right. Such a statute would clearly be unconstitutional. The Legislature can regulate enforcement of that right, but cannot eliminate that right. If the Commission perceives that there is a "problem" for private homeowners where they are having work done on their homes, then the alternatives which your consultant has suggested should be carefully considered.

Dated: April 5, 2000

Respectfully submitted,
Gordon Hunt

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