Study H-820 June 13, 2000

Memorandum 2000-37

Mechanic's Liens: Draft Proposals

This memorandum presents three reform proposals for Commission review, briefly discusses some additional matters, and considers some general drafting issues involved in the mechanic's lien law reform project.

The following materials are attached:

CONTENTS

SCOPE OF SPECIAL REFORMS

Discussions before the Commission and many of the materials we have reviewed focus reform proposals on residential real property, single-family, owner-occupied dwellings, home improvement contracts, or other such formulations. At some point, the Commission will need to decide the scope of any special consumer protection reforms to be proposed. We here discuss some of the possibilities, particularly since Sam Abdulaziz has included a scope proposal in his package of reforms. It is not critical for the Commission to decide the scope at this point but it would be useful.

Contracts and liens concerning this type of property have been the focus of Assembly Member Mike Honda's bills in the 1999-2000 session. The lien recover fund in AB 742 would have applied to "owner-occupied residential property." The companion constitutional amendment in ACA 5 would have carved out an exception in the constitutional mechanic's lien provision for a "single-family, owner-occupied dwelling that is the primary residence of the owner of the property."

The stalled "HIPP 2000" initiative from the Contractors State License Board (CSLB) was directed toward home improvement contracts. (For background on HIPP, see First and Second Supplements to Memorandum 2000-9; the HIPP proposal was also discussed in Part 2 of Gordon Hunt's Report, attached to Memorandum 2000-9, and is the basis for part of Sam Abdulaziz's proposal attached to this memorandum as Exhibit pp. 3-17.) HIPP tied into the special home improvement rules in the Contractors' State License Law, which are not limited to single-family, owner-occupied dwellings, or even to the broader class of owner-occupied dwellings. Business and Professions Code Section 7151.2 defines home improvement contract as "an agreement … between a contractor and an owner or between a contractor and a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, if the work is to be performed in, to, or upon the residence or dwelling unit of the tenant, for the performance of a home improvement." The statute provides a broad definition of "home improvement":

> 7151. "Home improvement" means the repairing, remodeling, altering, converting, or modernizing of, or adding to, residential property and shall include, but not be limited to, the construction, erection, replacement, or improvement of driveways, swimming pools, including spas and hot tubs, terraces, patios, awnings, storm

> windows, landscaping, fences, porches, garages, fallout shelters, basements, and other improvements of the structures or land which is adjacent to a dwelling house. "Home improvement" shall also mean the installation of home improvement goods or the furnishing of home improvement services.
>
> For purposes of this chapter, "home improvement goods or services" means goods and services, as defined in Section 1689.5 of the Civil Code, which are bought in connection with the improvement of real property. Such home improvement goods and services include, but are not limited to, carpeting, texture coating, fencing, air conditioning or heating equipment, and termite extermination. Home improvement goods include goods which are to be so affixed to real property as to become a part of real property whether or not severable therefrom.

Although the experts and stakeholders disagree about the extent of the "double payment problem" (which includes both the problems facing homeowners and unpaid subcontractors and suppliers), the staff believes that there is general consensus that, when it does occur, the effect can be significant to the homeowner involved. The evidence, although it is anecdotal, cannot be dismissed. While prior discussions may have focused on single-family, owner-occupied dwellings, this class is probably too limited from a public policy standpoint. The basis for separate treatment of a class of customers is their presumed lack of legal sophistication and familiarity with the intricacies of the home improvement business, as well as the special protections long afforded the home. Consequently, the **staff recommends applying these special protections consistent with the home improvement contract rules in the Contractors' State License Law.**

Whatever scope is settled on, we will need to provide sufficiently clear rules so that the parties can tell when the special protections are applicable. This suggests that the best approach would be to tie in to some existing scheme, such as the home improvement rules or some other fairly well-understood category of relationships.

THREE APPROACHES

Three proposals have surfaced in the last several months: Sam Abdulaziz has proposed a set of revisions in the notice provisions and remedies in existing law; James Acret has suggested implementing a defense based on prior payment to

the contractor; and Ellen Gallagher has offered a new direct pay proposal. These three proposals are discussed below.

There are many other options, of course, such as making only a few minor or technical revisions in existing law, mandating payment bonds or joint control accounts, specifying a percentage of the contract price to be held back as "retainage," and replacing lien rights with recovery funds. (For an overview, see Memorandum 2000-26, considered at the April meeting.) We do not intend to discuss any of these options unless the Commission expresses renewed interest in one or more of them.

Notice and Remedy Package (Abdulaziz Proposal)

Sam Abdulaziz has presented a set of proposals to address concerns regarding home improvement projects. (See Abdulaziz Memorandum, Exhibit pp. 5-17.) Mr. Abdulaziz reiterates his view that in the home improvement business, the subcontractors are not necessarily any more sophisticated than the homeowner. (*Id.*, p. 5). Neither party may be well-versed in the remedies available under the law, so basing remediation on assumptions about only one side's lack of familiarity with the law could put the other parties at a disadvantage. To the staff, this suggests the need to simplify the law to the extent possible; perhaps we have passed the point where further layers of tinkering can be productive. This may be the gist of the referral by the Assembly Judiciary Committee to the Commission in the first place.

The Abdulaziz proposal includes the following elements:

(1) Limit special remedies to "original contracts" over $5,000 concerning single-family, owner-occupied dwellings
(2) Improve notice procedures: "Mechanic's Lien Warning"
(3) Require blanket payment bond for home improvement contracts
(4) Simplify joint control agreements — check writing service
(5) Increase license bond from $7,500 to $10,000
(6) Require $100,000 liability insurance policy

While these features can be treated as "stand alone items," they are offered as a "comprehensive package [to] protect the consumers without adversely affecting the construction industry in a wholesale manner." (*Id.*, p. 8.)

(1) Contracts over $5,000 concerning single-family, owner-occupied dwellings

The proposed revisions would apply only to "original contracts" over $5,000 concerning single-family, owner-occupied dwellings. (*Id.*, p 6.) Below that amount (or some other appropriate dollar level), the claimants won't foreclose on a mechanic's lien because it is not economical, since attorney's fees are not covered by the lien. Mr. Abdulaziz argues that "it is foolhardy to change an entire system that has worked for over a hundred years, with really no evidence to substantiate the need for the change. This is especially true when the change would most likely require a constitutional amendment."

As discussed in the previous section, the staff thinks that limiting remedies to single-family, owner-occupied dwellings is too limited. If the Commission decides to adopt this proposal, **we suggest the broader home improvement contract coverage.**

Mr. Abdulaziz writes "we don't believe that there should be any change for 'service and repair work' or for work below a certain value. Attorneys tend to suggest a million dollars worth of insurance to cover a hundred thousand dollar risk." (*Id.*) The staff does not know whether the $5,000 figure is the appropriate threshold. The Contractors' State License Law does not apply to projects where "the aggregate contract price which for labor, materials, and all other items, is less than five hundred dollars ($500), that work or operations being considered of casual, minor, or inconsequential nature." Bus. & Prof. Code § 7048. We read Mr. Abdulaziz's proposal to set a dollar amount, and not to provide an additional exception for "service and repair" work regardless of dollar amount.

As to the scope of the $5,000 limitation, **the staff does not believe the $5,000 limit, if adopted, should be applied to all of the proposals in this package.** For example, the license bond increase would have to apply regardless of the amount of the contracts that may be made. We assume that the dollar limit is most appropriately applied to sending the special notice and to the blanket payment bond proposal. This needs to be clarified, if a dollar limit is adopted.

(An aside: Unlicensed contractors — meaning those who are required to be licensed but are not — do not have mechanic's lien rights under Business and Professions Code Section 7031. We do not find any explicit provision in the mechanic's lien statute excluding unlicensed contractors, although there are penalties for the failure of a licensed contractor to give the Notice to Property Owner under Civil Code Section 3097. In theory, a contractor who is not required to be licensed could have a lien under the mechanic's lien law and the

constitution, since the bar in the Contractors' State License Law would not apply. Of course, many other persons who are not subject to licensing laws could also have lien rights.)

(2) Improved notice: "Mechanic's Lien Warning"

The improved notice scheme, based in part on the CSLB's proposed Home Improvement Protection Plan ("HIPP 2000"), would (1) change the name of the "Notice to Owner" given by the prime contractor at the start of a project to "Mechanic's Lien Warning," (2) require the prime contractor to obtain written confirmation from the owner that the warning had been received, (3) make failure to give the notice and get confirmation a violation of the Contractors' State License Law, subjecting the prime contractor to discipline, (4) make injuries arising out of the failure to give the warning compensable from the license bond, and (5) include a checklist to assist the owner in determining whether all important steps had been taken. Mr. Abdulaziz has included proposed language for the warning and the checklist in his memorandum. (See Exhibit pp. 9-17.)

The consensus at prior meetings is that the notice given the owner by the prime contractor before the work begins should be improved. Whether any style or wording revisions can achieve the desired goal is questionable. It is worth the effort to make notices clearer and more direct, but the improvements may be marginal. Requiring confirmation may help in some cases, and addresses the issue raised in CSLB correspondence concerning whether the prime contractor bothers to give the required notice. But modern experience with signing preprinted forms suggests that the confirmation may end up being just another piece of paper to be signed with other items. We don't want to be too negative about this proposal — it appears to be beneficial and not too burdensome — but our expectations are not too high that it will cure the problems with the preliminary notice.

If the Commission decides to proceed with these suggestions, we would work on fine-tuning the language, working with CSLB and other interested persons. Ideally, however, the form language would not be in the statute. Statutory forms are cumbersome and become stale because of the burden of amending the statute to make some clarification. **The better approach is to provide statutory guidelines and direct the CSLB to flesh out the language by regulation. The staff recommends adopting this approach,** if the Commission approves this part of the Abdulaziz proposal.

(3) Blanket payment bond for home improvement contracts

A "blanket payment bond" in the amount of $50,000 would be required for anyone doing work on single-family, owner-occupied dwellings. (*Id.*, p. 7.) Failure to maintain this bond would be equivalent to failing to satisfy licensing requirements. This would not be a bond on each project, but "only a blanket payment bond, similar in concept to the license bond." (*Id.*)

This proposal appears to provide some genuine protection, as long as the licensed contractor is not in too deep financial peril. Discussion at prior meetings in connection with other bonding ideas suggests that many contractors would have trouble getting bonds that have to be underwritten. As we understand it, a bond in this amount would have to be underwritten and could not be issued by surety companies on a routine basis. Thus, **the staff questions whether this requirement is feasible.** Would such a bond requirement raise the threshold for entry into the industry to high? Or would it be a good thing if it acted to keep the smaller or financially fringier operators out of the home improvement business?

(4) Simplified Joint Control Agreement

In an effort to provide an inexpensive and efficient way to match releases with payments, but without the full escrow approach of the joint control companies, Mr. Abdulaziz proposes implementation of a check writing service. (*Id.*, p. 7.)

The staff is not sure if there are existing businesses that do this sort of thing, or if the joint control companies would jump in and offer the service. Mr. Abdulaziz suggests that it could be done economically with computer technology. Perhaps it is worth investigating, but we would be reluctant to attempting to legislate in this area, other than to recognize the possibility of such service or, better yet, directing CSLB to cover the subject by appropriate regulations. This type of service, it should be noted, could be beneficial regardless of the amount or type of the contract involved. If it is to be implemented, it should not be limited to home improvement contracts.

(5) Increase license bond from $7,500 to $10,000

Mr. Abdulaziz recognizes that the license bond "does not always inure to the benefit of lien claimants" but does cover license violations, and would cover situations where money is diverted from one project to another or where a project is abandoned. (*Id.*, pp. 7-8.) License bonds at a lower amount do not need to be underwritten and are economically feasible to the bonding companies

because of the number of bonds written. Mr. Abdulaziz suspects that an increase from $7,500 to $10,000 would not require additional underwriting. Swimming pool contractors are currently required to provide a license bond of $10,000 under Business and Professions Code Section 7171.6(b). In effect, the proposal would be to raise home improvement contractor license fees to the level set in 1994 for swimming pool contractors. (We assume that the proposal is limited to home improvement contracts or the subset of single-family, owner-occupied dwellings, but if it is time to raise the bond to keep pace with inflation and additional consumer protection demands, then the amount should be increased for all licensees.)

Six years ago the general license bond was raised from $5,000 to $7,500. (1994 Cal. Stat. ch. 26, § 206.7.) Adjusted for inflation, this amount would be $8,400 in 1999 terms. The original license bond amount in 1964 was $1,000, equivalent to about $5,300 in 1999 terms. (These figures are based on a consumer price index calculator on the Internet at <http://www.westegg.com/inflation/>.) The $2,500 increase proposed by Mr. Abdulaziz would be more than double the adjustment that would be needed to keep pace with inflation, but there is no magic number here, and if the 50% increase was justified in 1994, another 33% increase now is probably not out of line. On the other hand, we don't have to pay the increase, so it is easy for us to say. Presumably we will hear from the stakeholders if this proposal is adopted. It should be remembered, though, that any Commission proposal to increase the license bond would not take effect until 2002 at the earliest, making the adjustment from an inflationary standpoint more palatable.

Increasing the license bond may or may not be a useful initiative, but the staff does not think it would do much to address the problems we have been discussing. We assume there is built-in opposition from the small volume contractors since it would raise the costs of entry into business. In addition, the surety companies will be concerned if the bond amount approaches the point where underwriting is required, as Mr. Abdulaziz discusses. **On balance, the staff thinks this is a useful provision,** but more in terms of maintaining the license bond amount, not as a useful remedy where subcontractors or suppliers don't get paid or where the homeowner is faced with paying twice.

(6) $100,000 liability insurance

Mr. Abdulaziz expresses support for requiring a liability insurance policy in the amount of $100,000. It is not clear whether this would apply to all licensed

contractors or only home improvement contractors. He notes that this is the subject of SB 1524 (Figueroa) (which would have abolished the license bond except for swimming pool contractors), but the bill was amended on May 1 to delete the insurance provision and bonding changes. As amended, SB 1524 provides that a homeowner should be able to recover on the bond without the necessity of showing a "willful or deliberate" violation of the license law. **The staff thinks it is not advisable for the Commission to pursue the liability insurance proposal.** The earlier form of the bill was sponsored by the Department of Insurance, which argued that the license bond was an "illusory" protection and that the public was mislead into thinking they were protected by the bond when they could rarely recover. (See Senate Committee on Business and Professions Consultant's Analysis of SB 1524, as amended April 3, 2000.) The insurance proposal was opposed by the surety companies and by insurers who argued that low-volume contractors would not be able to afford the insurance. The May 1 amendments returned the bill to its original form; as reported in the analysis, "upon reviewing the current version of the bill, some sureties have approached the bill's sponsor and offered to enter into serious negotiations concerning reform of the license bond structure if the elimination of the bond is taken out of the bill."

The Senate Floor Analysis of SB 1524, as amended May 1, 2000, includes some interesting commentary from the Department of Insurance:

> Existing law generally requires that a licensed contractor's disregard for "accepted trade standards for good and workmanlike construction," "departure from or disregard of plans or specifications," or "failure or refusal to prosecute a construction project or operation with reasonable diligence causing material injury to another" must be shown to be "willful" to be grounds for disciplinary action by the Contractors' State Licensing Board. Licensees are required to carry construction bonds for all jobs, which are underwritten by surety companies. These bonds are required to indemnify a number of parties who may be harmed by a licensed contractor's failure to perform, including homeowners contracting for home improvements damaged as a result of a licensee's violation of state law. The minimum value bond required to sustain an active contractor's license is $7,500, with one exception.
>
> Though there are over 90 insurers licensed to do business as sureties in California, the vast majority of them write contractors' bonds primarily as an accommodation to other insurance

> customers; in fact, a half-dozen companies do most of the business in low-end surety bonds for contractors.
>
> The Department has learned, both through routine market conduct examinations and through complaints against them filed by homeowners, subcontractors, suppliers and others, that surety companies have relied on the "willful and deliberate" clauses in existing law to avoid paying claims against their bonds. Requiring a claimant to demonstrate that a bonded contractor's conduct constituted a "willful and deliberate" violation of state law, especially in the absence of a final disposition by the license regulator, is a difficult burden to bear. If the claimant is a legally-unsophisticated homeowner against whom this burden is not supposed to be applied in the first place, it is practically insurmountable.

It appears the Legislature is actively working on this issue. The Commission historically avoids duplicating the efforts of others. Practically speaking, it does not appear to be a fruitful proposal to address mechanic's lien issues.

Conclusion

Overall the Abdulaziz proposal is an incremental set of revisions to the current law, with some grander proposals such as the blanket payment bond and liability insurance requirements. It addresses the potential double payment problem in the home improvement field using existing mechanisms and following the general trend of statutory amendments and CSLB initiatives over the last few years. To the extent that there are mandatory costs imposed on all licensed contractors by the payment bond, license bond increase, this proposal shares the objection to the recovery fund proposals that all contractors have to pay for the sins of the dishonest, foolish, and incompetent contractors. The staff thinks there are severable viable proposals in this package, and they should be considered as add-on options regardless of whether more fundamental revisions are made.

Full Pay Defense (Acret Proposal)

The Acret proposal — providing a defense against mechanic's lien enforcement if to the extent the owner has paid the contract price in good faith — has been discussed from the perspective of constitutionality in Memorandum 2000-36. The proposal addresses the double payment problem head on, protecting good faith owners from the possibility of having to pay subcontractors or suppliers for amounts that have been paid under the contract terms. The

proposal is outlined in Mr. Acret's letter to Assembly Member Mike Honda of August 25, 1999 (see Second Supplement to Memorandum 2000-9, Exhibit p. 15):

> The essentials could be established by legislation that would include the following provisions:
>
> 1. A lien claimant other than an original contractor dealing directly with the owner of a home improvement project may not enforce a claim of mechanics lien if:
>
>   a) the original contract price established by the owner and the original contractor represents a good faith evaluation of the value of the work to be performed and the equipment and materials to be supplied under the original contract, and
>
>   b) the owner has paid to or for the original contractor the original contract price as established by the contract documents including any signed change orders.
>
> 2. If the owner has paid part, but not all of the original contract price, the amount of all mechanics lien claims shall not exceed the difference between the original contract price and the amounts paid by the owner in good faith to or for the original contractor.

As noted in Memorandum 2000-36, this basic rule was in place during the "contract era" from the 1850s until the "direct lien" was legislated in 1911.

One major benefit of the Acret proposal is that it is partly self-enforcing. It elevates the law of contract to its usual place of importance in business transactions. It is simple to understand, in part because it conforms to normal expectations. In these days of highly statutory procedures, statutory forms, practice guidebooks, seminars, and all of the other detritus of the legal and commercial world, it may be difficult to accept a simple rule as set out above. In 1872 it might have been possible to declare a basic rule and expect the parties to develop their practices and procedures based on it, but we are not sure it can be done that way today. If the Commission is inclined to incorporate this approach in a set of recommendations for revision of mechanic's lien law, it will need to be refined and supplemented, and presumably limited to home improvement contracts.

What should a subcontractor or supplier do to protect its position under this rule? The simplest approach would be to give notice to the owner so that payments can't be made "in good faith" to the contractor. This does not settle the issue, though, since it doesn't tell the parties what they should do next. One option would be to provide for a direct pay notice, so that the subcontractor or

supplier who has not been paid can not only hold up further discharging payments to the contractor but also ask to be paid directly. Put another way, the Acret proposal may lead inexorably to the Gallagher proposal, as we give in to the temptation to spell the details out. Instead of permitting subcontractors and suppliers to continue to give the preliminary notice and rely on their lien rights against the owner's property as a back up to their contract rights with their contractor, in the special set of home improvement contracts under consideration, they would be forced to be more vigilant in making sure payments were made to them in a timely fashion or they would need to give notice to the owner to prevent the discharge from operating.

The staff does not have enough familiarity with the workings of the construction industry to make useful judgments about whether the bare form of the Acret proposal would work. The court in *Roystone Co. v. Darling*, 171 Cal. 526, 533-34, 154 P. 15 (1915), characterized the pre-1911 scheme (which differed in detail from the Acret proposal) as follows:

> The scheme of regulation embodied in the amendments of 1885 and continued until 1911, did not work well in practical operation. Disputes frequently arose concerning the terms of contracts, the time of maturity of installments, the making of payments, the time of beginning the work, with respect to the filing of the contract for record, and many other details which, under the somewhat elaborate plan of the statute, would affect the validity of the contract, or the right to a lien to the unpaid part of the price when the contract was valid. Our reports show many decisions on these questions. Amendments to the statute were made from time to time, but, upon the whole, conditions were not improved. The act of 1911 was obviously designed for the purpose of removing, as far as possible, the objections to the former law.

We don't want to get sidetracked on a detailed consideration of the law between 1885 and 1911, but it should be noted that part of the problem discussed in *Roystone* had to do with the bifurcation of rights depending on whether the contract was valid or not. If valid, then the contract controlled the rights of the subcontractors; if invalid, then they had direct liens of the scope existing today, but limited only by the value of their labor or materials, not the contract price. It is not necessary to recreate the complexities of that era in order to implement a scheme combining the Acret and Gallagher proposals, but it is important to recognize that even a simple scheme at the beginning stages can become far more complex as it is adjusted in response to competing interests.

Direct Pay Plan (Gallagher Proposal)

At the April meeting, Ellen Gallagher outlined a proposal that would give an option to subcontractors and suppliers to request direct payment from the owner instead of giving the preliminary notice. (Ms. Gallagher's letter was distributed generally following the meeting, attached to the Second Supplement to Memorandum 2000-26; another copy is attached to this memorandum as Exhibit pp. 19-25.) The Commission requested the staff to prepare a draft of the Gallagher direct pay proposal for consideration at this meeting, but the staff regrets that it has not found the time to complete the assignment. What follows is a discussion of its elements and issues that Ms. Gallagher and the staff have identified.

At the heart of the direct pay plan is an indisputable logic: if the subcontractor and material supplier can impose a direct lien on the owner's property, then the owner should be able to pay these potential claimants directly and avoid all of the trouble. If a statutory scheme can reflect the common sense of this approach, we should be able to avoid the confusion and turmoil of the existing statute. That, of course, remains to be seen.

The preliminary notice under Civil Code Section 3097 is given within 20 days after commencement of work or delivery of material to the site. It is intended to give the owner notice of potential lien claimants, but the problem is that the homeowner can't make any direct response to the preliminary notice; instead, as we have learned, the knowledgeable and prudent homeowner could consider using any of the available optional responses — e.g., requesting a payment bond from the prime contractor (hard to get for most contractors, an additional expense, and a little late after the contract is in place), using joint checks (which may not be effective as a protection), making sure conditional releases are obtained before payments are made (which can be complicated working through the contractor), or using a joint control service (an additional expense, requiring specialized knowledge). In addition, the "preliminary" notice may actually come in after the owner has paid for the work in question, since the notice acts to preserve rights to lien claimants arising within 20 days prior to delivery of the notice. The word "preliminary" does not refer to the time before work commences or before payment is made.

As explained in Ms. Gallagher's April 12 letter, the most common reason for a prime contractor's failure to pay subcontractors and suppliers is that the contractor is in financial trouble. "CSLB's experience with contractors who go

bankrupt is that long before the bankruptcy, the contractor's performance deteriorates in quality and timeliness. Delays, abandonment, poor workmanship, all accompany the contractor on the way to bankruptcy." (Exhibit p. 20.) Hence, the subcontractor or supplier can protect itself by investigating the contractor's creditworthiness and then decide whether to rely on payment through the contractor or request direct payment from the owner. Under the direct pay plan, the subcontractor or supplier gives a notice to the owner that involves specific actions (pay me) and consequences (or suffer a lien) that should be understandable and can be acted on in a relatively brief time.

The direct pay approach, like the Acret full pay defense, places a greater reliance on direct contractual relations between the owner and subcontractors, and seeks to restore a balance of risk and reward that is missing in the existing direct lien system.

> Right now, the homeowner's money, credit rating and, perhaps, the home itself are in the hands of the contractor and subcontractor. Direct Pay shifts responsibility out of possibly irresponsible hands and places it where it belongs. The subcontractor is responsible for the decision to extend credit. If the contractor does not have sufficient credit, the homeowner would be asked to pay direct.

(Exhibit p. 21.) Ms. Gallagher warns that "no one will like this, at first," but she believes that once the transitional period is over, it would work for financially competent parties.

In effect, the subcontractor or supplier is forced to make an election of remedies when it determines whether to give the direct pay notice. Depending on the technicalities of the scheme (i.e., whether the non-direct pay branch is based on the preliminary notice scheme in existing law or based on the Acret proposal), potential lien rights are determined at the point when the decision is made to send the direct pay notice. The intent of the proposal is to encourage or require subcontractors and suppliers to look to the creditworthiness of the contractor who engaged their services and make a rational decision based on that information. It is assumed that this is the standard model operating today in most areas of commerce; it is not a new thing.

The staff has not been able to pinpoint the time when the election should be made. A simple, understandable procedure needs to have clear steps so that busy, legally unsophisticated parties can act and know the consequences of their actions. It is assumed that the current flurry of preliminary notices and later

procedural deadlines are not understood by many of the parties in home improvement contracts. The direct pay notice has the potential to be much clearer to the homeowner and the subcontractor because it can be given and acted upon, unlike the preliminary notice. But while it may clarify the situation for the homeowner, it replaces the routine issuance of preliminary notices by subcontractors and suppliers with the need to make a decision based on an assessment the best of two options.

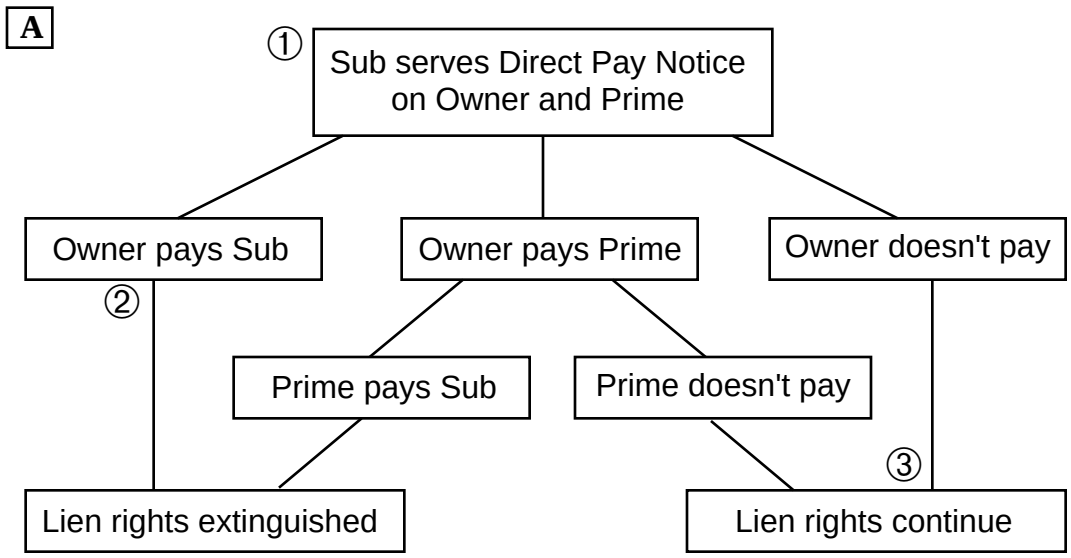
We can only speculate on how the various segments of the industry might respond. Ms. Gallagher analyzes their several interests in her April 12 letter, which we will not repeat here. (See Exhibit pp. 21-25.)

In the following two sections, we set out a version of the direct pay proposal based mostly on Ms. Gallagher's materials:

A. Direct Pay Flowchart — DPN Given

As discussed above, the subcontractor or supplier decides whether to follow the direct pay route, based on an assessment of the contractor's (or upstream subcontractor's) creditworthiness. (In the diagram, "sub" means subcontractors and material suppliers; "prime" means prime contractor or upstream subcontractor.)

If the subcontractor decides *not* to rely on the creditworthiness of the prime contractor (or upstream subcontractor) and *seek payment directly* from the owner, then these options exist:



Notes (keyed to numbered items):

① In view of the consequences of the election, the Direct Pay Notice (DPN) should be delivered with some formality, so we have provided for service. IN addition, notice is given both the owner and the person with whom the notice-giver has contracted with. Unresolved is the critical issue of whether there should be preconditions to service of the DPN. There needs to be some support for the subcontractor's or material supplier's claim to payment. How will the owner know whether the claim is valid, whether the contracted for services have been performed, and whether the job is finished? If the subcontractor or supplier has a right only to be paid in installments in the case of a job extending over a longer period, should the DPN be served when each installment comes due? Or should one notice be sufficient to cover all future payments until rescinded?

The staff suggests that the contract between the subcontractor or supplier and the contractor or upstream subcontractor should be attached to the DPN. One notice should be sufficient to cover future work and right to payments. In effect, service of the DPN acts to establish privity between the owner and the subcontractor or supplier serving the notice, by way of a unilateral contract. If the owner complies with the terms stated in the DPN, then the logical consequences follow. The notice should also spell out the terms and explain any installment payments and the conditions precedent to the right to payment.

② If there are no disputes, then payment from the owner to the subcontractor at this point eliminates the lien right. But what happens if there is a dispute between the contractor and the subcontractor? The payment would take care of the claim of the subcontractor, but it may turn out that the subcontractor should not have been paid. We are concerned that the homeowner may be trading too much away to be able to avoid the double payment problem. The prime contractor who is doing its job should be making sure subcontractors and suppliers are conforming to the contract and to the building codes. If the owner pays the subcontractor directly, there is no profit or incentive for the prime contractor to do these things.

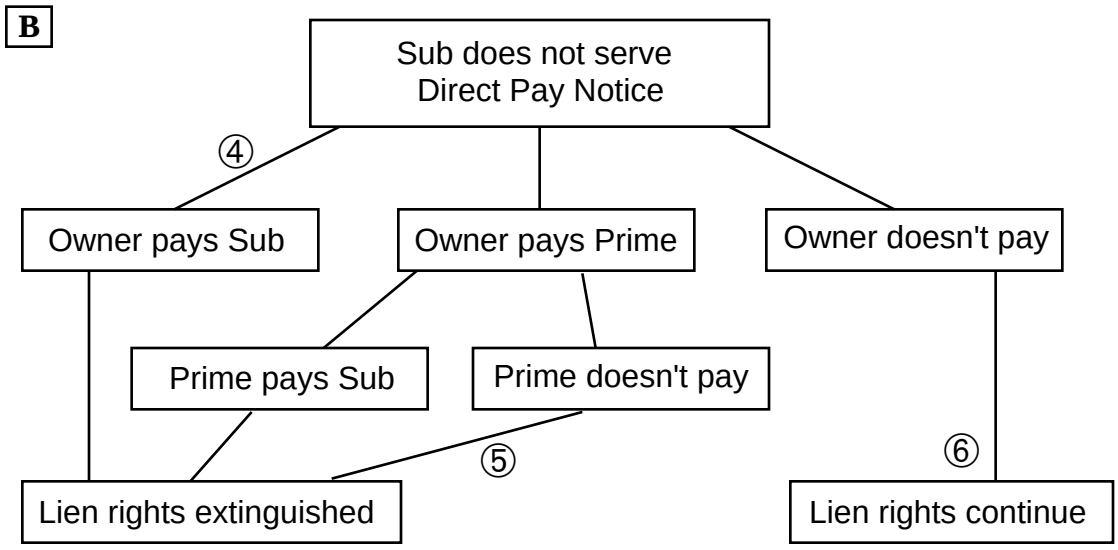
③ This is the situation where the mechanic's lien rights of the subcontractors and suppliers need to be maintained, since the owner has not made the payments necessary to prevent liens. We do not want to reinvent the existing procedure at this point, and it wouldn't work very well as currently designed. One great

advantage of the direct pay proposal is that the flurry of preliminary notices is avoided.

The staff suggests that if the owner does not make payments to the contractor or anyone else who is due, then a notice of lien would be the appropriate response and the preliminary notice would not be required. There should be a time provided for the owner to make payments to the contractor or, better, to the person giving notice of lien and demand for payment. Lien rights would be established with the same priorities as exist now, but we envision that they would be better for subcontractors and suppliers with valid unsatisfied claims, because they would not be limited to the 20-day period under the existing preliminary notice regime.

B. Direct Pay Flowchart — DPN Not Given

If the subcontractor decides to *rely on the creditworthiness* of the prime (or upstream subcontractor) and *not seek direct payment* from the owner, then these options exist:



Notes (keyed to numbered items):

④ This branch of payment to the subcontractor by the owner in the absence of a DPN is not likely and we haven't thought much about it, but it is included here since it is one of the logical possibilities.

⑤ We anticipate that this step may be the most controversial. It would implement the Acret proposal in the "classic" double payment situation, i.e.,

where the owner has paid the prime contractor, but the prime has not paid the subs or suppliers. This is a critical feature of the Gallagher proposal, since otherwise the purpose of the direct pay option would be undermined. There must be a consequence to relying on the creditworthiness of the prime contractor, and here is where it comes into play.

⑥ At this point, we have the same issue as discussed in item (3) under the diagram A.

Next Steps

The staff regrets not providing a full draft of these ideas. Not infrequently we find that an idea that looks brilliant in outline form disintegrates when it is run through the drafting grinder. We are also concerned that this proposal could become too complicated, if we are not careful, and end up being as confusing and convoluted as the existing preliminary notice approach. We are still optimistic that the drafting can be done, as long as we resist over-detailed rules. The premise that the more direct approach reflected in the Gallagher and Acret proposals can be drafted more simply has yet to be tested. The establishment of some kind of post-contract privity between the owner and the subcontractors and suppliers should help avoid the existing complications.

ADDITIONAL MATTERS

Other Reforms

The discussions concerning special rules for home improvement contracts should not obscure the fact that there are other reforms to consider. As staff and Commission time permit, we intend to begin reviewing the proposals listed in Part 1 of Gordon Hunt's Report to the Commission (attached to Memorandum 99-85), as well as issues raised in correspondence from Sam Abdulaziz and others.

We also plan to discuss Assembly Member Margett's AB 171, which proposed revisions in the rules governing notice of completion, when we review general reform proposals. AB 171 died in the Assembly Judiciary Committee. We did not consider this proposal originally because of the Commission's practice of not duplicating current legislative efforts, but we understand in this case that the progress of the bill may have been affected by the potential for a broader, more comprehensive revision of the entire statute to be proposed by the Commission.

There are also a number of law review articles that raise issues the Commission should consider.

Drafting Principles

For general information, and especially for those who are not familiar with the Commission's drafting style, we would like to note some basic principles we plan to follow.

The Commission seeks to draft statutes with short sections. This makes the law easier to find and to understand. In addition, when sections need to be amended, it is more efficient to deal with short sections than lengthy ones. This is consistent with long-standing drafting principles and with Joint Rule 8. The entire mechanic's lien law in the 1872 Code of Civil Procedure was set out in 17 brief sections, covering about four pages and amounting to maybe 1200 words — less than half the length of Civil Code Section 3097 in the current statute.

Definitions should not contain substantive rules. For example, Civil Code Section 3097 is ostensibly a definition of "preliminary 20-day notice (private work)," but the section lays out a full procedure at great and daunting length. It has been amended 14 times since its enactment in 1969, most recently in Chapter 13 of the Statutes of 2000.

We will strive to avoid statutory forms. In the past, the Commission has proposed a number of statutory forms in its recommendations. That experience teaches that it is a task to be avoided. Where there is a responsible agency that can maintain forms by regulation (or by court rule), the best course is to provide statutory guidelines and the barest minimum of specific language, and leave the rest to nonlegislative maintenance.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

LAW OFFICES OF
ABDULAZIZ & GROSSBART
A Partnership of Professional Corporations

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SAM K. ABDULAZIZ
A Law Corporation

KENNETH S. GROSSBART
A Law Corporation

June 6, 2000

SENT VIA US MAIL AND E-MAIL

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

RE: MECHANIC'S LIEN STUDY

Dear Mr. Ulrich:

This is our proposal and is in response to various other proposals up to and including those presented at your last meeting.

First, I commend you on the amount of work that you've done and the knowledge of the process that you have gained. We are enclosing a discussion draft of our proposal dealing with the mechanic's lien issue. I believe the enclosure is self explanatory. We are also sending the documents to you by e-mail if that makes it easier for you to handle.

With respect to other matters in your memorandum, dealing with changes that could be made now, we agree with Assembly Member Margett in total as to a Notice of Recording a Notice of Completion. We would also reiterate that the recording of a Notice of Completion is a discretionary act on the part of the owner.

Another item that can be corrected presently, is the Legislative confusion dealing with the term "Original contractor." We believe that term should be changed to "prime contractor." That is the language that is used in the trade. We also don't believe that the term should be changed to "general contractor." Under the Contractors License Law, a general contractor is typically a classification "A" or "B" contractor. Although the general contractor is usually a prime contractor, that is not always the case. Many general contractors are subcontractors with respect to such matters as framing.

The Legislature has confused the public and attorneys in the Preliminary Notice area, by using the words, "Except the contractor... all persons who have a direct contract with the

6454 COLDWATER CANYON AVENUE / NORTH HOLLYWOOD, CALIFORNIA 91606-1187

owner..." Civil Code section 3097(b). This language creates an ambiguity as to which contractor is referred to here. That statutory language does not state "original contractor," yet all contractors who have a direct contract with the owner are defined by Civil Code section 3095 to be "original contractors." Thus, who is excluded from the requirements of Civil Code section 3097(b), if anyone?

With respect to the statement of the scope of Mechanic's Liens on page six of the report handed out at the last meeting, the lien created in favor of architects and engineers, is Legislative in nature. It does not arise out of the Mechanic's Lien constitutionality. That is the very reason that it can be restricted by the legislature as it has been in the Civil Code section cited. It is not a restriction on a constitutionally protected right. Further, unlike a Mechanic's Lien, it arises prior to any improvement of the property.

I hope this draft helps in the process.

Very truly yours,
ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ

SKA:dak
Encl.

cc: clients

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DISCUSSION DRAFT MEMORANDUM

Submitted to the

CALIFORNIA LAW REVIEW COMMISSION'S MECHANIC'S LIEN STUDY

June 6, 2000

By

Sam K. Abdulaziz

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June 6, 2000

DISCUSSION DRAFT MEMORANDUM

After a great deal of thought, some study, and discussions with others, we submit a discussion draft solution that we believe best balances the interests of owners, prime contractors, and others who are affected by, or who have mechanic's liens or stop notice rights. Whenever the term "mechanic's lien" is used in this proposal, it is meant to deal with the entire bundle of rights that inure to those who improve real property (i.e. stop notice rights, bond rights, etc.).

In this draft we have tried to define the problem and propose solutions.

INTRODUCTION

The California Law Review Commission has heard a great deal of testimony and anecdotal comments, containing little - if any - empirical data. Indeed, the staff has now come up to speed in understanding the problem. **It is admitted that there is no readily available source to determine the scope of the problem. Indeed, we believe that everyone agrees that the overall scope of the problem is not significant.** We also understand that if you are the affected owner or claimant, the scope to you is significant.

THE NATURE OF THE PROBLEM

From everything that we've heard, the situation where problems arise is generally in the area of improvement to owner-occupied single-family residences, and does not involve the commercial, industrial or public works sector. This is evidenced by the fact that the Contractors Board has suggested a Home Improvement Protection Plan and Assemblymember Honda suggests a recovery fund on owner-occupied single-family residences. Mr. Honda's plan does not stretch to the commercial, industrial, or public works sector.

Presumably, the primary reason for problems primarily occurring in the single-family residence sector is that you have a less sophisticated owner and less sophisticated contractors dealing with owner-occupied single-family residences. This is the very reason that I had previously stated that our experience indicates that subcontractors doing work on owner-occupied single-family residences, are really no better equipped to protect themselves than is an owner on the same projects.

Therefore, we believe that any proposed solution should deal only with owner-occupied single-family residences. We believe it is foolhardy to change an entire system that has worked for over a hundred years, with really no evidence to substantiate the need for the change. This is especially true when the change would most likely require a constitutional amendment.

In addition, we don't believe that there should be any change for "service and repair work" or for work below a certain value. Attorneys tend to suggest a million dollars worth of insurance to cover a hundred thousand dollar risk. In reality, service and repair contractors or others who do work under a specific sum, perhaps $5,000, will probably never foreclose on a lien even though liens may be recorded. That is because there is no attorneys' fees recovery provided in mechanic's lien actions. A complaint on a mechanic's lien is not a complaint on a contract and therefore, even if the contract contains an attorneys' fees clause, the attorneys' fees could not be awarded on a mechanic's lien cause of action.

Therefore, we suggest that the changes only apply to owner-occupied single-family residences where the original contract exceeds $5,000.

THE PROPOSED FIX

As stated above, we believe that the problems are caused by the lack of sophistication of all parties within that sector. Therefore, the cornerstone of this proposal is based on additional notice requirements and protection afforded to the owners. Unfortunately, the proposed fix was not thought of by us. The proposed fix is based on the Contractors' State License Board's Home Improvement Protection Plan (HIPP) and we have merely refined the Board's proposed language in the Preliminary Notice Form and other documents to better work within the industry.

The name of the "Notice to Owner" presently required under Business & Professions Code Section 7018, should be changed to "Mechanic's Lien Warning." With that change, the language should change to the proposed language. A copy of the proposed form is attached as Exhibit "A." The very purpose of the "Notice to Owner" is to inform the owner of the possibility of a lien being placed on that owner's real property. Therefore, the proposed name and language change is more consistent with that purpose. We also propose that Business & Professions Code Section 7018 be amended to (1) require the "Mechanic's Lien Warning" rather than the "Notice to Owner," and (2) that the prime contractor be required to obtain written confirmation from the owner, indicating that the owner has in fact received the new notice. The failure to give the required notice and obtain a confirmation would be deemed a violation of the license law and subject the prime contractor to discipline.

We would also clarify that if an injury arises out of the failure to give the "Mechanic's Lien Notice," that would be a subject that would be covered by the statutory license bond.

We have also taken another idea from the CSLB. That idea deals with check lists to be given along with the contract as well as other check lists for each payment request. We modified the Board's language slightly. Like the proposed new "Mechanic's Lien Notice," the owner should acknowledge receipt, and any deviation by the contractor from the proposed procedure would be grounds for discipline. We enclose copies of the check lists as Exhibit "B-1" and "B-2."

ADDITIONAL PROTECTION

We also believe that the following items would give significant protection to the owners in owner-occupied single-family residences and would not adversely affect the possible mechanic's lien claimants to a significant degree.

1. A blanket payment bond. A blanket payment bond in the amount of $50,000, would be required for anyone doing work on owner-occupied single-family residences. Business & Professions Code Section 7031 should be modified to reflect that not having that bond would be tantamount to not having a contractors license with respect to owner-occupied single-family residences. If those bonds are mandated for the home improvement industry, we truly believe that the cost of the bonds would be reduced substantially. I am not talking about a payment and performance bond on each project, only a blanket payment bond, similar in concept to the license bond; i.e. not for a specific project.

2. A simplified "Joint Control Agreement." Because of the bonding, inspections, etc. required of joint control companies, mandating the use of such companies could adversely affect the cost of doing business. We would suggest a new procedure that would not require a bonded joint control company but merely a check writing service of some sort. That procedure would be to assure, to the extent possible, that there are no liens on the project. The company proposed would not need to be a joint control company. It would not need to actually hold any of the funds. What it would do is obtain appropriate releases from every one who had given preliminary notices, and before allowing an owner to make any payment, the proposed company would secure a release executed. The release would then be held by the service and a check prepared by this service would be written which would be signed by the owner. With our present state of computer technology, we believe that this type of service would be nominal in cost.

3. Increase the amount of the license bond. Although the license bond does not always inure to the benefit of lien

claimants, it does cover violations of the license law. Diversion of funds from one project to another as well as from one portion of a project to another can be covered by the license bond. Failure to complete a project for the price stated, can be covered by the license bond. Therefore the license bond does provide some protection.

The license bond has not been increased for approximately five years. One of the reasons that bonding companies have given for not increasing the license bond is the fact that they would then have to "underwrite the bond." At present, the bond is based on numbers. The more bonds a company write, the more likely it will at least break even on these bonds. Given the approximate five year lapse since the last increase, we would suspect that it would not substantially impact the underwriting decisions of the bonding company to increase the bonds by approximately $2,500.

4. General liability insurance. Although this would not be a solution to any mechanic's lien problem, we believe that this proposal would go hand in hand in the consumer protection area. General liability insurance covers things that a bond does not. We would suggest that each contractor affected be required to purchase general liability insurance in the amount of $100,000. It should be noted that there presently is a bill pending before the Legislature (SB 1524 Figueroa) that would require that type of insurance. My understanding from the proponents of that bill, is that such insurance would cost approximately $1,000 annually.

As an attorney representing contractors I believe such insurance helps to protect contractors as well as owners. The cost of the defense of a construction dispute is significant. Insurance would greatly reduce that burden while protecting the owner as well.

SUMMARY

The items suggested are stand alone items and can be deleted if the Commission believes that they should be. However, we believe that this comprehensive package would protect the consumers without adversely affecting the construction industry in a wholesale manner. Further this proposal would not do away with the constitutionally protected procedure that has worked for over 100 years.

Respectfully submitted,

Sam K. Abdulaziz
SKA:tmw

MECHANICS' LIEN WARNING:

TO AVOID LIENS ON YOUR HOME

PLEASE READ THIS WARNING CAREFULLY [1]

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

You may not realize, however, that subcontractors, laborers, material suppliers and other parties that contribute to your home improvement project also can place a lien on your home, land, or property. This can happen even if you have paid your contractor in full if the subcontractor or other provider of work or materials is not paid.

HOW TO PROTECT YOURSELF

Inform yourself about liens and ways to prevent them. The Contractors State License Board (CSLB) can provide you with a pamphlet describing liens and how they work. You can get a copy of the pamphlet, "Don't Lien on Me -- Mechanic's Liens," by calling

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[1] Note: This language may change based on the outcome of the Law Review Commission's recommendations.

the CSLB information number 800-321-CSLB (2752) or by accessing the CSLB website (www.cslb.ca.gov).

Watch for Preliminary Notices. Subcontractors, material suppliers, and some other claimants are required to provide you with a document called a "Preliminary Notice" if they want to preserve their rights to record a lien against your property. This notice must be given to you within 20 days of the date the lien claimant provides goods or services. Keep the Preliminary Notices in a safe place so you can refer to them for payments. The Preliminary Notice informs you of your obligation to make sure that you or your contractor pays the claimant. Be aware that when jobs are completed quickly, the Preliminary Notice may not be sent until after the job is complete.

Obtain a list of possible claimants. If you don't know whether the contractor has arranged for subcontractors, laborers, and material suppliers to provide material or services to your project, ask your contractor for a list of whom he/she might use. A prudent consumer matches this list with the scheduled payments described in the contract to determine when payment is due to each subcontractor, material supplier, etc., contributing to your work of home improvement. You may also want to compare this list with the possible lien claimants who send you Preliminary Notices to make sure all possible lien claimants are accounted for.

Ways to make sure that possible lien claimants are paid include:

1. Get a Conditional Waiver and Release. Prior to making payment to your contractor, obtain a Conditional Waiver and Release form signed by those who worked on your project for which payment is being made. Read that form carefully. The way this usually works is a two-step process. First, you should exercise your right to require your contractor to provide you with a signed Conditional Release from each possible lien claimant. In each Request for Payment (bill or invoice) presented to you, your contractor should give you this Conditional Release. The Release refers to the part of the lien claimant's work covered by the bill. A signed Conditional Release tells you that the lien claimant has agreed to release his or her right to a lien in accordance with the release, once the lien claimant is paid. After you pay the contractor and before you make any more payments, you should insist that the contractor provide you with an Unconditional Release signed by each lien claimant for the part of the work for which you have made payment.

Three things to remember: First, no matter how many separate progress payments are made in your project, there will probably be only one Preliminary Notice per claimant. Second, each Conditional or Unconditional Release covers only the subcontractor, material supplier or laborer who signs it and covers only the portion of work for which payment is made.

The exact language of a lien release is set forth in Section 3262 of the Civil Code. Most stationery stores will sell "Waiver and Release" forms if your contractor does not have them.

Beware: an Unconditional Release from your contractor covers only the contractor's claim, not the subcontractors, material suppliers and laborers.

2. Hire a joint control service. Joint control companies, licensed by the Department of Corporations, are bonded and are available throughout the state. In using these companies, you pay the joint control company and the joint control company pays the contractor, subcontractor, material supplier etc. A good joint control company will obtain lien releases whenever they make payment.

3. Issue joint checks. Under the joint check scenario, you issue checks for payments made out to **both** the contractor and the subcontractor or material supplier involved in the project. This will help to insure, although it does not guarantee, that all persons due payment are actually paid. You will still want to get Conditional and Unconditional Releases.

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

contractor may pass the cost of this bond (1% to 5%) on to you, the homeowner.

Finally, understand that license bonds have limitations. Although your contractor must post some form of financial security with the CSLB, usually in the form of a contractor's license bond, this $7,500 ($10,000 for a swimming pool contractor) bond may be the only financial security available to cover all damages caused by a contractor's violation of the Contractors' License Law. Some consumers make the mistake of believing the entire bond amount will be available if they are injured. Be careful. In some cases, the owners may be competing with other consumers or the contractor's, subcontractors, and material suppliers for a payment from this same bond. Consequently, relying on the contractor's license bond to cover your loss may be a mistake.

"Checklist for Homeowners"

Does your home improvement contract include?

__ The name, address, and license number of the contractor, and, if a salesperson negotiated the contract, the name and registration number of the salesperson?

__ The approximate dates when the work will begin and the construction will be completed?

__ If the work being done includes a swimming pool, a plan and scale drawing showing shape, size, dimensions, and construction and equipment specifications for the swimming pool?

__ A description of the work to be done, materials to be used, and the equipment to be used or installed?

__ If a down payment is charged, is the down payment the lesser of $1,000 of 10 percent of the contract price, excluding finance charges (or $200 or 2 percent of the contract price for swimming pools)?

__ A schedule of progress payments showing the amount of each progress payment as a sum in dollars and cents?

The schedule of progress payments should be tied to the amount of work to be performed and to any materials and equipment to be supplied, i.e., payment is for progress. A prudent homeowner pays only as work is completed, not before. Exception: You may legally pay a contractor all or most of the money up-front if the contractor provides you with payment and performance bonds. These payment and performance bonds protect you in case the contractor is unable to perform. These bonds are not the same as the contractor's license bond.

__ Did your contractor give you a copy of the Mechanics' Lien Warning?

A person or business contributing to your home improvement project may file a lien on your home to insure that he or she is paid. Until "released," the lien interferes with your property title. In fact, your home could be sold, after a court trial, to satisfy a lien even if you have paid your contractor in full. You should have gotten information about liens from your contractor in the form of a "Mechanics' Lien Warning." You can get more information by accessing CSLB's web site at www.cslb.ca.gov or by requesting information from the CSLB at 800-321-CSLB (2752). Ask for a copy of the CSLB pamphlet, "Don't Lien on Me!"

___ Have you arranged for your contractor to provide you with a list of all proposed lien claimants, and have you arranged for conditional releases signed by each proposed lien claimant to be given to you at the time you make your progress payments? Likewise, is your contractor prepared to give you unconditional releases for the work covering the last progress payment before you make another payment?

See the Mechanics' Lien Warning and/or the pamphlet, "Don't Lien on Me!"

___ Finally, if you plan to make any changes or additions to your contract, did you know that these changes should all be in writing?

Placing changes in writing reduces the possibility of a later dispute.

"Progress Payment Checklist for Homeowners"

Contractor's Name:
Address:
License Number:

Unless payment and performance bonds or a joint control company is provided, a prudent homeowner pays only as work is completed, not before. The schedule of progress payments set out in your contract should have been tied to the amount of work to be performed and to any materials and equipment to be supplied. Except for the down payment, your payments to the contractor should be for progress only. By paying only as work is completed, you maintain more control over your home improvement contract.

Lien Prevention

By law, your contractor is required to give you a copy of the Mechanics' Lien Warning, a notice created by the Contractors State License Board to inform you of ways to prevent liens. A copy of that notice appears on the back of this sheet.

As described in the Mechanics' Lien Warning, a person or business contributing to your home improvement project may record a lien on your home to insure that he or she is paid. Until "released," the lien may interfere with your property's title. In fact, after a trial, your home could be sold to satisfy a lien even if you have paid your contractor in full. Unless you and your contractor have specifically agreed in the contract on some other lien prevention plan, such as a payment and performance bond or a joint control agreement as approved by the Registrar of Contractors, you should make sure you get releases from each possible lien claimant.

Conditional Releases

When your contractor requests a Progress Payment, he or she should also provide you with Conditional Releases signed by any subcontractors, material suppliers, etc. who provided work and equipment and contributed to the completion of the progress described for the corresponding Progress Payment. Read that document carefully. A Conditional Release affirms that the subcontractor, material supplier, etc. has agreed to waive all lien rights as stated in the release, through a certain date once he or she has been paid.

Unconditional Releases

Once you have gotten Conditional Releases signed by each possible lien claimant and you have made the progress payment to your contractor, your contractor should pay those possible lien claimants and get Unconditional Releases from them after that payment. Your contractor should then provide those releases to you for your records. The most effective way a homeowner can manage payment is to require Unconditional Releases for the last Progress Payment before paying the next Progress Payment. You can get more information by accessing CSLB's web site at www.cslb.ca.gov or by requesting information from the CSLB at 800-321-CSLB (2752). Ask for a copy of the CSLB pamphlet, "Don't Lien on Me!"

State of California Department of Consumer Affairs

CONTRACTORS STATE LICENSE BOARD
9821 BUSINESS PARK DRIVE/ P.O. BOX 26000
SACRAMENTO, CALIFORNIA 95826
(916) 255-4000

May 15, 2000

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

Dear Mr. Ulrich:

Re: **Mechanics' Liens**

In the April 13, 2000 Minutes, you note that the Commission declined to change the name of the name of the mechanics' lien. Could you revisit this decision? If the Commission decides to adopt the direct pay approach or Mr. Acret's full payment approach, there will be a statutory separation between residential liens and other kinds of liens. We might avoid confusion if residential mechanics' liens were clearly distinguished from other liens. I suggest three categories of liens called "Subcontractor's Residential Lien," "Material Supplier's Residential Lien" and "Laborer's Residential Lien."

Thank you for the opportunity to participate in this process. If you have any questions, please call me at 916-255-4116.

Sincerely yours,

Ellen Gallagher

Ellen Gallagher, Staff Counsel
Contractors State License Board

State of California Department of Consumer Affairs

CONTRACTORS STATE LICENSE BOARD
9821 BUSINESS PARK DRIVE / P.O. BOX 26000
SACRAMENTO, CALIFORNIA 95826

April 12, 2000

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

Dear Mr. Ulrich:

Re: **Mechanics' Liens**

The Contractors State License Board (CSLB) has not yet met to discuss mechanics' liens and Assemblyman Honda's proposed recovery fund. However, CSLB staff wanted to include this proposal in the overall discussion of mechanics' liens to get feedback from interested parties. As you know, CSLB staff has been reviewing this area of law for some time. We have paid particular attention to the circumstances that cause liens and the way homeowners respond to them.

Introduction

When asked how to prevent liens, one of CSLB's Enforcement Deputies suggests paying subcontractors and material suppliers direct. Why not? A plan called Direct Pay is described below.

Background

Home Improvement Law

The law governing home improvement contracts is based on the idea that the homeowner should not pay until various phases of the work are satisfactorily completed. Except for the down-payment, it is illegal for a contractor to collect money up-front to pay for goods and services. The payment for progress scheme was adopted to reduce fraud and abandonment in the home improvement arena and to encourage homeowners to have control over their projects.

When a homeowner fails to pay a contractor for goods and services rendered under a home improvement contract, the contractor has two options. The contractor can sue the homeowner in civil court based on the property owner's breach of contract or the contractor can file a mechanics' lien.

When a contractor fails to pay a subcontractor or material supplier (hereinafter, subcontractor only), the subcontractor has two options. The subcontractor can sue the contractor in civil court based on the contractor's breach of contract, or the subcontractor can file a mechanics' lien on the homeowner's property.

There are a number of reasons a contractor might fail to pay the subcontractor.

The contractor may not have been paid by the homeowner. This is the situation where it makes sense to allow the subcontractor or material supplier to go directly against the homeowner by pursuing lien rights.

There may be a dispute about the work or material-- the work or material was defective in some way.

There may be a dispute between the contractor and the subcontractor about another job. Perhaps the contractor has already paid the subcontractor for a previous job but later decides to dispute its quality. Another variation of this occurs when a contractor is carrying an open account with a subcontractor. When the contractor pays, the payment is credited to other debt, leaving the debt that is the basis of the lien unpaid. Although these liens are removable, the homeowner still has to deal with them.

More often, however, the contractor does not pay because he or she doesn't have the money. The contractor has gotten too far ahead financially. Instead of paying the subcontractor for this job, the contractor uses the money to pay some other subcontractor or material supplier owed from a previous job. If a contractor gets too far ahead for too long, he or she will ultimately go bankrupt. CSLB's experience with contractors who go bankrupt is that long before the bankruptcy, the contractor's performance deteriorates in quality and timeliness. Delays, abandonment, poor workmanship, all accompany the contractor on the way to bankruptcy.

Direct Pay

Under a Direct Pay plan, the subcontractor and material supplier would decide whether to extend credit to the contractor. In making this decision, a subcontractor could look to his or her own records for credit information. The subcontractor could also use any one of the available credit check sources. The Internet has made this kind of information readily available.

If the subcontractor decides the contractor is not credit worthy, the subcontractor would ask for Direct Pay. Instead of providing a traditional Preliminary Notice, the subcontractor would send a Direct Pay Notice to the homeowner. The Direct Pay Notice would say something like --

> Don't pay the contractor. When the contractor informs you it is time to pay for the services/material I have provided for your project, Pay Me Directly instead.

If you pay the contractor, instead of me, and the contractor fails to pay me, I will place a lien on your house. (This is modeled after the Texas lien notice statutes).

If the subcontractor has confidence in the contractor, the subcontractor could send a modified Preliminary Notice informing the homeowner that, if the contractor is not paid, the subcontractor will file a lien.

Responsibility Shifted

Right now, the homeowner's money, credit rating and, perhaps, the home itself are in the hands of the contractor and subcontractor. Direct Pay shifts responsibility out of possibly irresponsible hands and places it where it belongs. The subcontractor is responsible for the decision to extend credit. If the contractor does not have sufficient credit, the homeowner would be asked to pay direct. The homeowner is responsible for making payments directly.

The plan substitutes the complicated preliminary notice scheme with the relatively simple direct payment. The plan does not affect lien rights, constitutional or otherwise. If the contractor fails to pay the subcontractor because the homeowner fails to pay the contractor, the lien rights are still viable.

Discussion

No one will like this, at first. It is a change and, in the construction industry, change is bad. Once the transition is over, however, it may work out very well for everyone who is financially competent.

Contractors

Contractors who do a good job and have good credit will continue to be paid and to pay the people who work for them. Contractors who are working beyond their credit capacity will be restrained.[1] Contractors with bad credit will have to improve their credit if they want to take on more work. This would be good for the whole industry. In the meantime, subcontractors and material suppliers would ask to be paid directly.

Another reason contractors with poor credit won't like it is the new notice will tell the homeowner exactly the amount due to the subcontractor, exposing the mark-up attached to the subcontractor's work (and material supplier's supplies). This situation may provide a powerful incentive to quickly acquire a good credit rating.

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[1]The Nevada Board's step-bonding program rests on this same principle. Contractors should not take on larger jobs than their financial status can support.

Subcontractors

Subcontractors may not like it to start with. They have to take responsibility for their credit choices. If they opt for direct pay, they may risk the wrath of contractors who may prefer other subcontractors who do not assert direct pay rights. Contractors may attempt to place pressure on subcontractors not to seek direct pay. But pressure not to file mechanics' liens has already been addressed by law, surely pressure not to assert direct pay rights could be addressed as well.

Pressure on subcontractors notwithstanding, here is where the public policy comes in. When subcontractors extend unwarranted credit to a contractor, they are not risking their own money, they are risking the homeowner's money, credit and home. Subjecting homeowners to liens based on the subcontractor's poor credit decision is unfair to homeowners, particularly when the ways to prevent liens are inexplicable at best.

Homeowners

One criticism of Direct Pay is that it is too complicated for homeowners. Granted, compared to the present situation where an unwary homeowner *fails to take any steps at all* to prevent liens, Direct Pay is more complicated. The Direct Pay procedure draws the homeowner into the relationship between the subcontractor and the contractor. While the homeowner may not want this, as long as lien law exists, the homeowner will be drawn in. The question is- will we involve the homeowner *before* a lien is filed or *after*?

Of course, the homeowner is drawn in only when the contractor does not have sufficient credit.

On the other hand, if a homeowner is following the suggestions offered by law on how to prevent liens, Direct Pay is much less complicated. The following discussion of liens illustrates the complications of the present system.

Notice to Owner

The law presently requires contractors to present homeowners with a notice called the Notice to Owner. The first problem is that contractors routinely fail to present homeowner with the Notice. (One of the provisions of CSLB's Home Improvement Protection Plan (HIPP) was to attempt to strengthen penalties for failure to provide notices).

The Notice to Owner is designed to provide homeowners with information about mechanics' liens and to suggest certain ways to prevent them. The second problem is the Notice is extremely confusing and difficult to read. CSLB's HIPP proposal includes a more user friendly version of this notice, called Mechanics' Lien Warning. CSLB staff acknowledge, however, that the user friendly version is still awfully complicated. The Notice describes four approaches to lien prevention-- signed releases, joint control accounts, joint checks and payment and performance bonds. Frankly speaking, the Notice is so intimidating that it is this author's belief that the few homeowners who actually read the Notice are not illumined by it.

Signed Release

The Notice suggests that consumers should protect themselves from mechanic's liens by getting signed releases. The Preliminary Notice (the notice designed to inform the property owner of the possibility of liens) (not the Notice to Owner or the Notice to Property Owner) also stresses this approach.

How does the release system work (or not work)?

- The homeowner must make clear to the contractor that he or she will not pay unless releases are provided. Business people working in the commercial trades do not hesitate to request releases. However, the few homeowners who know about mechanics' liens are reluctant assert their right to lien releases. Contractors, subtly and not so subtly, lead homeowners to believe among other things that releases will hold up the job, are not really necessary and signal that the homeowner doesn't trust the contractor. The homeowner fears the contractor will "take it personally." A homeowner's reluctance to challenge the contractor is understandable. Bluntly put, "When the house is tore up and you're already behind schedule, the last thing you want is your contractor mad at you."

- The releases work as follows: When the contractor presents the homeowner with a bill for a scheduled payment that includes the work of the subcontractor, the contractor must also provide a release signed by the subcontractor. Unfortunately, this release is really a conditional release. It is not effective unless the subcontractor is, in fact, paid. Once the subcontractor is paid, the subcontractor is supposed to provide the contractor with an unconditional release[2]. The unconditional release is rarely supplied even when the contractor is routinely paying the subcontractors.

- There are a number of pitfalls for homeowners that arise out of the way lien notice law has been formulated. First, the Preliminary Notice describes a release but does not distinguish a conditional from an unconditional release. Second, the Preliminary Notice simply refers to a release, not a release by a subcontractor or material supplier. This misleads homeowners into thinking that a release by the contractor is sufficient. Third, business people working in commercial construction understand that there is only one Preliminary Notice no matter how many services are provided or goods delivered. Homeowners don't understand this. Homeowners do not understand that a release through January 1, 200X does not cover work done or services provided after January 1, 200X, although there will be no additional Preliminary Notice. Finally, the Preliminary Notice can be presented to the homeowner after the work is done and the contractor has already been paid. Other than that, it works pretty good.

There are three other suggested approaches: Joint Control Accounts, Payment and Performance Bonds, and Joint Checks.

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[2]There is some messiness concerning when an unconditional release is actually only a conditional release that are addressed by lien experts contributing to this dialogue. This will not be addressed here.

Joint Control Accounts

Under a joint control account, a third party is hired to make appropriate payments as the work progresses. The joint control agent may pay the subcontractors and material suppliers directly or may track payments by the contractor through the conditional/ unconditional release format. The cost to the homeowner for using this service is said to be between 3% and 5% of the contract.

This option is selected when a bank is specifically financing a home improvement project. Under this scheme, the home improvement is financed in line with the home's equity *after* the remodel is complete. To make sure the bank is not left with a loan exceeding the home's value, the bank insists that a joint control account be used. The bank charges the homeowner for the cost of the joint control.

This option is almost never chosen by homeowners. A homeowner with sufficient sophistication to understand the risks of liens, often believes he or she is sophisticated enough to personally keep track of the project by making sure all subcontractors and material suppliers are paid.

Payment and Performance Bonds

These bonds cover both the risk of liens through non-payment and the dangers of poor performance. Except for blanket bonds available to the very large contractors like Home Depot and Sears, these bonds are rarely available to contractors working in the home improvement sector.

Even if the bond was restricted to guaranteeing payment, industry maintains that most contractors would fail to qualify.

Thus, unless some kind of step bonding approach was devised, requiring these bonds would probably result in closing the home improvement market to small contractors.

In some ways, Direct Pay addresses the same issues as a payment bond. However, instead of allowing the contractor to be given control of the homeowner's money and using a bond to cover the situation where the contractor fails to pay, the homeowner holds the money and pays direct.

Joint Checks

Of the solutions presently suggested, joint checks is by far the simplest. When the contractor presents a bill for the subcontractor's work, the homeowner writes a joint check. There are a number of problems with this approach. First, like all the other suggestions, the homeowner rarely knows about the problem. Contractors fail to give the notice. If the notice is given it is in with all the contract gobbledegook and homeowners don't read it. If they read the notice, it provides so many suggestions that it is hard to wade through. If the homeowner focuses on joint checks, the problems of intimidation described above start in with special emphasis on the idea that the joint check will just hold things up.

Direct Pay Loose Ends

While Direct Pay is considerably less complicated than the conditional/unconditional procedures suggested by the present Notice to Owner, homeowners still must pay attention. If the homeowner gets a direct pay notice, he or she must directly pay or risk a lien if the contractor fails to pay. The plus for homeowners is that this plan is much more understandable than present lien notices. It says: Wait. Don't pay the contractor. When the contractor presents the bill for my services, pay me directly.

Direct Pay also keeps the homeowner out of situations where the homeowner has paid but the contractor has a dispute about some other job with the subcontractor. On the other side of the spectrum, Direct Pay also keeps the homeowner out of situations where the subcontractor files a lien based on a dispute with the contractor about some other job. While these liens are not difficult to remove, they are frustrating and scary for homeowners, and often require the services of an attorney.

There is incidental plus. The Direct Pay plan focuses the homeowner on what has been done and when. It forces everyone to look at the schedule of payments and follow the strategy built into the home improvement law -- *Do not let the money get ahead of the work. Make sure the subcontractors and suppliers are paid.* Keeping performance ahead of money greatly decreases loss from contractor bankruptcy and abandonment as well as liens.

Secondary Subcontractor

The situation is a little less straight forward when a subcontractor hires another subcontractor or material supplier. The best solution is to adopt the same strategy. The secondary subcontractor or material supplier decides the hiring subcontractor is good for the money or sends the direct pay notice.

Timing

We should also include a provision that prohibits a contractor from taking payment before 21 days (the days needed for a homeowner to receive a direct pay notice).

I know this description is very rough. I present it only to round out the mechanics' lien discussion. Thank you for the opportunity to participate in this process. If you have any questions, please call me at 916-255-4116.

Sincerely yours,

Ellen Gallagher, Staff Counsel
Contractors State License Board