Study H-820 September 29, 2000

Memorandum 2000-63

Mechanic's Liens: Home Improvement Payment Bond

At the July meeting, the Commission reviewed preliminary drafts of the direct pay proposal and the full-payment defense proposal, both of which are now on the back burner while we consider other options. For the meeting, the Commission directed the staff to investigate a mandatory payment bond in home improvement contracts equal to 50% of the contract price, up to a level such as $25,000.

The background of this type of bonding and some policy issues are discussed in this memorandum. A rough draft of a 50% payment bond statute is attached for discussion purposes.

Fifty Percent Payment Bond Under Existing Law

California law has provided an optional 50% payment bond for almost 90 years, although it appears not to be widely known and not frequently used, especially in the home improvement arena. However, this existing remedy is the inspiration for the draft proposal currently under discussion, and so we need to understand how this remedy is supposed to work. The existing 50% payment bond statute raises some issues that will need to be resolved to provide a useful consumer protection scheme for home improvement contracts.

A general definition of "payment bond" is provided in Section 3096, for purposes of the mechanic's lien law generally (emphasis added):

> **§ 3096. Payment bond defined**
>
> 3096. "Payment bond" means a bond with good and sufficient sureties that is conditioned for the *payment in full of the claims of all claimants* and that also by its terms is made to inure to the benefit of all claimants so as to give these persons a right of action to recover upon this bond in any suit brought to foreclose the liens provided for in this title or in a separate suit brought on the bond. An owner, original contractor, or a subcontractor may be the principal upon any payment bond.

The 50% payment bond is covered in Sections 3235 and 3236 (emphasis added):

> **§ 3235. Fifty percent payment bond**
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> 3235. In case the original contract for a private work of improvement is filed in the office of the county recorder of the county where the property is situated *before the work is commenced*, and the payment bond of the original contractor in an *amount not less than 50 percent of the contract price* named in such contract is recorded in such office, then the court must, *where it would be equitable so to do*, restrict the recovery under lien claims to an aggregate amount equal to the amount found to be due from the owner to the original contractor and render judgment against the original contractor and his sureties on such bond for any deficiency or difference there may remain between such amount so found to be due to the original contractor and the whole amount found to be due to claimants.
>
> **§ 3236. Purpose, limitation on owner's liability**
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> 3236. It is the intent and purpose of Section 3235 to limit the owner's liability, *in all cases*, to the measure of the contract price where he shall have filed or caused to be *filed in good faith* his original contract and recorded a payment bond as therein provided. It shall be lawful for the owner to protect himself against any failure of the original contractor to perform his contract and make full payment for all work done and materials furnished thereunder by exacting such bond or other security as he may deem necessary.

These provisions date back to amendments made in 1911, when the "contract era" gave way to the "direct lien era." Section 14 of the 1911 act explained the intent of the reform:

> The provisions of this act shall be liberally construed with a view to effect its purpose. They are not intended as a reënactment of the provisions of former statutes, with the policy heretofore impressed upon the same by the courts of this state, but are intended to reverse that policy to the extent of making the liens provided for, direct and independent of any account of indebtedness between the owner and contractor, thereby making the policy of this state conform to that of Nevada and the other Pacific coast states.

The former limitation on a good faith owner's liability to the amount of the contract was abolished through imposition of the "direct" lien on the property by persons not in privity, thereby permitting the double liability problem. A part of the former regime was preserved, however, in what appears to be a compromise form: the 50% payment bond. See 1911 Cal. Stat. ch. 681, § 1 (adding Code Civ.

Proc. § 1183; 1951 Cal. Stat. ch. 1159 (continuing the former sections in Code Civ. Proc. § 1185.1(c)-(d)); 1969 Cal. Stat. ch. 1362, § 2 (continuing the former sections in Civ. Code § 3235-3236, where they remain, unchanged and little used, since 1969). The direct lien language continues today in Civil Code Section 3123, which explicitly recognizes the exception in Sections 3235 and 3236 permitting limitation to the contract price.

The "equitable so to do" language in Section 3235 raises some doubts about the meaning and effect of the section. Under what circumstances can the court decide it is not equitable to limit the owner's liability? It is difficult to tell from the statutory language. Section 3236 speaks of filing in good faith, but neither section says who is doing the filing. It would not be appropriate if the contractor's bad faith were to defeat the protection of the owner. The only cases we have discovered interpreting this language found it was not equitable to enforce the contract amount limitation where the sureties were insufficient. See *Simpson v. Bergmann*, 125 Cal. App. 1, 13 P.2d 531 (1932); *S. R. Frazee Co. v. Arnold*, 46 Cal. App. 74, 188 P. 822 (1920). In a *mandatory* 50% payment bond scheme, the lack of good faith would not be a relevant factor.

Commentary on the 50% payment bond in California is sparse. We don't find any discussion of it in Sam Abdulaziz's book, California Construction Law (2000 Edition, ed. K. Grossbart). The CEB mechanic's lien book describes the procedure as a "reasonably effective but under-used method of limiting an owner's liability." Flaig & Matson, *Representing the Owner*, in California Mechanics' Liens and Related Construction Remedies § 8.38, at 468.1-69 (Cal. Cont. Ed. Bar, 3d ed., Dec. 1999 update). Presumably because of the "where it would be equitable to do so" language, the CEB authors state: "By recording the bond, the owner *may reduce the likelihood* that he or she will not be required to pay claimants any amount in excess of the contract price." *Id.* at 469 (emphasis added; the word "not" should be omitted to keep this sentence on track).

The Marsh treatise reports that use of the recorded contractor's payment bond under Sections 3235-3236

> is wide-spread among well-informed business firms and corporations. Unfortunately, most individual owners are not sufficiently aware of this protection to make adequate use of it. On the other hand, the average person who wishes to have a home built might not be able to avail himself of this protective apparatus even if he wanted to, for the reason that his contractor is likely to be "unbondable," and the cost of the bond is another factor ….

M. Marsh & H. Marsh, California Mechanics' Lien Law and Construction Industry Practice § 2.9 at 2-5 (6th ed. 1999).

Bond Availability and Cost

A standard criticism of mandatory bonding proposals is that it would drive many contractors out of business, not necessarily because they are bad apples but because they can't meet the underwriting standards imposed by the surety companies. Some have expressed the view that a bit of housecleaning is in order and that some meaningful measures must be taken to improve the health and perception of the home improvement industry. The effect of a mandatory payment bond would depend to a great extent on the amount of the bond and how the surety industry responds in setting premiums and making bonds available.

The idea as roughed out at the July meeting is to set a bond amount that is low enough to avoid decimation of contractor ranks but high enough to provide the needed protection to the homeowner, as well as subcontractors and suppliers. We have used the suggested $25,000 contract amount in this discussion and the attached draft because we don't have any better amount to suggest. It seems appropriate, but we don't have any hard data to test it with. The maximum bond amount would then be $12,500, which is not much more than the swimming pool license bond ($10,000) — but, of course, a license bond is an annual blanket bond, and a per job payment bond is a greater expense and bureaucratic burden. Payment bond premiums generally range from 1% to 5%, depending on the financial wherewithal of the principal on the bond. Abdulaziz, *supra*, at 164.

Our discussions with surety company representatives and a surety association lobbyist suggest that some sureties would respond to this opportunity, but others (most?) would not. One company thought it could be done with a minimum of bureaucratic burden, and with premiums from 1% to 5%, depending on the usual factors influencing sureties, but that bonds would have to be fully collateralized in many cases. A "great credit risk" could get a bond for a 1% premium, according to one surety company; a "good guy" without a long history might have a 2% premium, with a trust deed collateral on his house. This, of course, would tend to eliminate some numbers of prime contractors, and it was suggested that any pressure of this sort would increase the underground economy risk. The problem at the bottom end could be that

many companies have a $100 premium minimum, which would represent a 10% premium on a $2,000 contract.

A lobbyist for one of the surety associations did not think that payment bonds of this type could be issued efficiently or routinely, but wanted to check further. It might work if there were a larger bond on file that could be tapped for each job.

The Commission considered bonding in general terms in its early review of the major options for reform of the mechanic's lien law. Memorandum 2000-26 reported that on small projects and in the home improvement area, bonds are not a practical option. The cost of a bond can be 1-5%, some subcontractors may have difficulty qualifying, and human nature is to avoid the trouble and expense of a bond until it is too late. Mandating payment bonds would add to the paperwork and expense of home improvement contracts.

As to payment bonds generally, Prof. George Lefcoe points out:

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

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

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

> [A]nother alternative would be to make the furnishing of a payment and a performance bond mandatory in the case of a single-family owner-occupied dwelling that is the primary residence of the owner. The Mechanic's Lien law could be amended to set forth appropriate provisions requiring bonding in those limited circumstances. The cost of the bonding, of course, is passed on to the owner and it would increase the cost of the project to the owner, but it would provide the owner with ultimate protection from a defaulting original contractor. It would completely serve to protect the owner from the failure of the original contractor to pay

> subcontractors, laborers, and suppliers. It would likewise protect the owner from failure to complete by the original contractor. The primary objection to any such statute would be claims by contractors that they would be unable to obtain such bonds because they are not "bondable." Those, of course, are the very contractors that shouldn't be in the home improvement business to begin with. If such a provision were enacted, the marketplace would react and surety companies would be willing to write such bonds and would find ways in the underwriting process to protect their interests. Specifically, sureties would take a more active participation in the projects that they bond for small contractors to insure that the money flows down from the contractor to the subcontractors, laborers, and suppliers. This would increase the cost of the bonds and thus the cost to the owner, but would provide the owner with much greater protection from defaulting original contractors. The cost of the bond would be much less than having to litigate and pay Mechanic's Liens.

Mr. Hunt also discusses mandatory bonding in his 1968 article, *California Mechanics' Lien Law: Need for Improvement*, 9 Santa Clara Law. 101, 105-11.

The CEB mechanic's lien treatise states:

> Bond premiums are expensive. To provide bonds to unknown or high-risk contractors, some sureties charge differential rates depending on the principal's financial capacity, past completion record, experience, and reputation. Other sureties simply decide whether to issue the bond at a set premium.…
>
> Not all contractors can get bonds. A surety will write a bond only if reasonably assured that it will never have to pay a bond claim. The primary factor examined by sureties is the liquidity and amount of commercially securable assets of the contractor seeking to be bonded, often based on financial audits of the contractor's business performed annually by an accountant. Shopping for companies with slightly lower standards (albeit higher rates) may prove fruitful for an owner seeking bond protection. Alternatively, the owner may limit the selection of contractors to those who have established accounts with surety companies and who will be able to obtain the required bonds.

Flaig & Matson, *supra*, § 8.37, at 468.

In connection with home improvement contracts, the Nolo Guide is generally negative:

> **Payment bonds usually mean attorneys**
> Payment bonds are not commonly used in private construction projects. They are even rarer in small works of improvement such

> as home improvement projects and single residence construction projects. If there is a payment bond in your situation, you'll almost certainly need an attorney to get your money out of the surety, because insurance companies are notoriously unwilling to cough up payment.

S. Elias, Contractors' and Homeowners' Guide to Mechanics' Liens 7/2 (Nolo 1998). In an example of a payment bond on a $20,000 second bathroom project, the Nolo Guide states that the premium would be roughly $1,500, amounting to a 7.5% charge. "When they learn that they will end up paying the premium as part of the cost of the entire job, they decide to put their money into a higher grade bathtub instead." *Id.*

As to the 50% payment bond under Section 3235, the Nolo Guide states:

> Although this approach to reducing mechanics' lien risk may seem like a good idea, most general contractors will not qualify for a payment bond equal to 50% of the overall project cost. In our example, not only would [the contractor] have to have enough credit or collateral to qualify for a $100,000 bond, but the cost of the bond would be somewhere in the neighborhood of $10,000, which would be economically unfeasible as well. As a general rule, this owner protection is seldom used exception extremely large projects involving highly bondable general contractors and price tabs that allow the cost of the bond to be absorbed in the larger project.

Id. at 9/12-9/13.

The draft proposal attempts to meet the concerns by mandating the bond (addressing the ignorance factor) and limiting it to a maximum of $12,500 and basing it on 50% of the contract price (addressing the availability and affordability concerns). Any bonding scheme will involve costs and paperwork, but the maximum bond in the proposal would likely cost from $125 to $625 (1-5% of 50% of $25,000), and we are hoping that surety companies can develop efficient ways to issue these bonds.

It is also interesting to note that the 50% payment bond under the 1935 Miller Act applicable to federal construction projects was replaced by the Construction Industry Payment Protection Act of 1999, Pub. L. No. 106-49, § 1, Aug. 17, 1999, 113 Stat. 231. (Under 40 U.S.C. Section 270a before amendment, the bond amount declined to 40%, between $1,000,000 and $5,000,000, with a maximum bond of $2,500,000 for jobs over $5,000,000.) Now Section 270a(a)(2) provides, in relevant part:

> The amount of the payment bond shall be equal to the total amount payable by the terms of the contract unless the contracting officer awarding the contract makes a written determination supported by specific findings that a payment bond in that amount is impractical, in which case the amount of the payment bond shall be set by the contracting officer. In no case shall the amount of the payment bond be less than the amount of the performance bond.

It appears at least in the federal arena that payment bonds less than the contract amount have lost favor.

Finally, note should be taken of a State Bar proposal in the late 1950s to require payment and performance bonds in the full amount of the contract price for all jobs over $25,000 (which would be about $145,000 in 1999 terms). (The State Bar study is described in Comment (Nock), *The "Forgotten Man" of Mechanics' Lien Laws — The Homeowner*, 16 Hastings L.J. 198 (1964).) Another proposal considered at that time set a lower threshold of $1,000 or $2,500 ($5,750 and $14,380, respectively, in 1999 dollars). The reason for excluding small contracts was the practical difficulty of securing and recording bonds for small projects, such as installation of a stove, which would be enormous in relation to the amounts and benefits involved. *Id.* at 200-01. Gordon Hunt's 1968 mandatory bonding proposal would have exempted jobs under $5,000 (over $24,000 in 1999 terms). Hunt, *supra*, at 106.

Constitutional Issues

The ability to limit liability to the contract amount with a 50% bond was upheld in the leading case of *Roystone Co. v. Darling*, 171 Cal. 526, 154 P. 15 (1915). The absolutist Justice Henshaw, concurring in *Roystone*, appears to have believed that even the optional bonding provision was constitutionally suspect:

> The owner may have paid the contractor (and he is not prohibited from so doing) everything that is due, and in such case this language would limit the right of the recovery of the lien claimant to what he could obtain under the bond. In short, he would have no lien upon the property at all. Here is as radical a denial of the constitutional lien as is found in any of the earlier statutes. The inconsistency between this language and other parts of the act is too apparent to require comment. Yet, as this seems to have been the deliberate design of the legislature, it is perhaps incumbent upon this court under its former decisions to give that design legal effect. If the legislature in fact means to give claimants the rights which the constitution guarantees them, as it declares its desire to do in section 14 [of 1911 Cal. Stat. ch. 678] …, it alone has the power

> to do so by language which will make it apparent that a lien claimant may still have recourse to the property upon which he has bestowed his labor if the interposed intermediate undertaking or fund shall not be sufficient to pay him in full. This court is, however, justified, I think, in waiting for a plainer exposition of the legislature's views and intent in the matter than can be found in this confused and confusing statute.

(*Id.* at 546.) Missing from the concurring opinion is any notion of balancing the rights of the owner against those of the lien claimants. And, of course, the era of consumer protection and greater regulation of commerce was decades in the future.

In an earlier case, mandatory bonding had been declared unconstitutional. *Gibbs v. Tally*, 133 Cal. 373, 376-77, 65 P. 970 (1901), invalidated the mandatory bond provision in Code of Civil Procedure Section 1203, as enacted in 1893, as an unreasonable restraint on the owner's property rights and an unreasonable and unnecessary restriction on the power to make contracts. This case was distinguished, but not overruled, in *Roystone*.

We do not believe that *Gibbs* would be good law today, and we do not recall hearing any suggestion to the contrary from any of the expert commentators who have been advising the Commission. The answer simply may be that the statute invalidated in *Gibbs* required the owner to obtain the bond, whereas the proposal under consideration here requires the prime contractor to obtain the bond. One commentator concludes that if the contractor alone pays the penalty for failure to get a bond, such as by revocation or suspension of license, "the statute would probably be justified as a reasonable regulation of the contracting business, comparable to … license bonds …." Nock, *supra*, at 203.

If the Commission or interested persons have further concerns about the constitutionality of mandating a minimal 50% payment bond, the staff can do more research into the issue.

Opt Out?

Should there be any provision for opting out of the protection afforded by the mandatory 50% payment bond? Obviously, in the unlikely event that a full payment bond is in effect, it would be redundant to have to get another lesser bond. But should a knowledgeable owner be forced to accept the protection of the bond if the owner would prefer to use a joint control agency or some other

mechanism to protect against double payment and ensure that payments get to subcontractors and suppliers?

A proposal set out in the Third Progress Report of the Senate Interim Judiciary Committee (1955) suggested a 25% retainage scheme as an alternative to mandatory bonding. This scheme promoted retainage, based on the statute in effect before 1911 applicable to contracts over $1,000 (equivalent to $18,000 in 1999 dollars), whereby 25% of the contract price was held until lien claims were all flushed out, with the bond as an alternative for the contractor who didn't want to wait that long to be paid.

Home Improvement Definition

At the last meeting, the Commission asked the staff to consider using home improvement language from the Contractors State License Law. Business and Professions Code Sections 7151 and 7151.2 provide the following definitions:

> 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.
>
> 7151.2. "Home improvement contract" means an agreement, whether oral or written, or contained in one or more documents, 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 as defined in Section 7151, and includes all labor, services, and materials to be furnished and performed thereunder. "Home improvement

> contract" also means an agreement, whether oral or written, or contained in one or more documents, between a salesperson, whether or not he or she is a home improvement salesperson, and (a) an owner or (b) a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, which provides for the sale, installation, or furnishing of home improvement goods or services.

The "home improvement" definition in Section 7151 is incorporated in the attached draft statute, but we would not use the "home improvement contract" definition, because it is inconsistent with the Commission's tentative decision, reaffirmed several times, to limit special protections to contracts on single-family, owner-occupied dwellings. If the Commission decides to pursue the 50% payment bond option for single-family, owner-occupied dwellings, further consideration will need to be given to issue of how a contractor will know that the site in fact is a single-family, owner-occupied dwelling.

Conclusion

The staff has not been able to follow all the threads that this proposal generates. The attached rough draft represents only the beginning of what a complete scheme would probably look like. We expect that expert commentators will find a number of problems that will require a solution before this proposal could be implemented.

We do not have enough familiarity with the bonding business to make reliable predictions on whether the mandatory bonding scheme would function as hoped. If major efficiencies of scale are not achieved, the bonding requirement would present a significant obstacle to the smaller contractor or the specialty "subcontractor" who deals with the owner. If the surety industry doesn't come forward with blanket plans or 10-packs or lines of bonding credit, the inefficiencies of requiring payment bonds on each home improvement job would overwhelm the intended benefits.

The proposal is based on the assumption that the double payment problem is most significant below a certain contract amount — hence, the working level of $25,000 suggested at the July meeting. As has been recognized, we do not have much data on the extent of the problem we are trying to solve. If the major problem is with, say, roofing contractors, then the $12,500 bond amount is probably appropriate. Even on larger jobs, by setting the maximum mandatory

bond at $12,500, we are assuming that the amount of potential double payment liability would not typically be much greater — but this is just a guess.

Another objection to this type of approach — putting yet another layer of statutory language in the Civil Code — is that we haven't made the law more understandable, particularly for the homeowner or the subcontractors and suppliers. The proposal does nothing to eliminate any paperwork under existing law, and will require more, since some type of enforcement mechanism is needed to make sure the contractor gets the required bond, and the homeowner will have to be informed about the existence and effect of the bond so that duplicate payments are not made where the bond should apply.

The 50% payment bond has the effect of shifting as much as $12,500 risk on each job from the owner or prime contractor to the subcontractor and supplier. This may be an appropriate reallocation of business risk, but it could happen under the draft proposal without making any significant beneficial changes in the way the parties do business and with the attendant costs of obtaining the mandatory bond.

Respectfully submitted,

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HOME IMPROVEMENT PAYMENT BOND

☞ **Staff Note.** For discussion purposes, this material is placed in Chapter 6 (commencing with Section 3235) concerning Payment Bond for Private Works, with two other articles. This draft is not integrated with the other parts of the mechanic's lien law, in part because the content and structure of the entire statute is subject to revision. If the Commission decides to pursue this approach, as the drafting is refined, these provisions would be integrated into the other sections, with appropriate cross-references and exceptions, depending on decisions concerning the broader statute. Additional revisions would have to be made such as amending the direct lien provisions in Section 3123 to recognize the exception of the home improvement payment bond, as it does with the 50% payment bond in Sections 3235 and 3236.

Civ. Code §§ 3244.1-3244.7 (added). Home Improvement Payment Bond

ARTICLE 3. HOME IMPROVEMENT PAYMENT BOND

§ 3244.1. Scope of article

3244.1. This article applies only to works of "home improvement," as defined in Section 7151 of the Business and Professions Code, on single-family, owner-occupied dwellings.

Comment. Section 3244.1 provides the scope of this article. See also Section 3106 ("work of improvement" defined).

☞ **Staff Note.** The text of Section 7151 is set out in Memorandum 2000-63.

§ 3244.2. Payment bond requirement

3244.2. Before commencing a work of home improvement, the prime contractor shall file a home improvement payment bond, in the amount required by this article, with the country recorder of the county where the property is located, along with a copy of the contract for home improvement.

Comment. Section 3244.2 states the basic filing requirements under this article. The procedure of filing the payment bond and a copy of the contract is drawn from Section 3235.

☞ **Staff Note.** This section is based on the assumption that all home improvement contracts are required to have the 50% payment bond, up to the maximum amount of $12,500, not just contracts up to $25,000. Otherwise, there would be an artificial "bright line" between contracts over $25,000 and those under $25,001.

"Prime contractor" is used because of the Commission's tentative decision to use that term instead of "original contractor."

A copy of the contract is filed, rather than the original, as required under existing Section 3235. Is filing the contract necessary? This provision is drawn from the existing practice and presumably is intended to provide evidence of the liability limitations as of the time of filing.

This draft does not say what happens if the payment bond is not filed, or if it is filed late, or if the contract copy isn't filed.

§ 3244.3. Amount of payment bond

3244.3. (a) Where the total amount payable by the terms of the contract for home improvement is twenty-five thousand dollars ($25,000) or less, the home

improvement payment bond shall be in the amount of not less than 50 percent of the total amount payable.

(b) Where the total amount payable by the terms of the contract for home improvement is greater than twenty-five thousand dollars ($25,000), the home improvement payment bond shall be in the amount of not less than twelve thousand five hundred dollars ($12,500).

Comment. Section 3244.3 sets the maximum amount of the mandatory 50% payment bond under this article. The parties may agree to a larger bond, but not a lesser bond. See also Section 3244.6 (waiver prohibited).

§ 3244.4. Terms of payment bond

3244.4. The home improvement payment bond shall provide that the prime contractor is the principal on the bond and that the lien claimants, other than the prime contractor, are beneficiaries of the bond.

Comment. Section 3244.4 sets out the principal and beneficiaries of the home improvement payment bond under this article.

§ 3244.5. Effect of payment bond

3244.5. (a) Where the total amount payable by the terms of the contract for home improvement is twenty-five thousand dollars ($25,000) or less, the owner's total liability is limited to the amount of the contract.

(b) Where the total amount payable by the terms of the contract for home improvement is greater than twenty-five thousand dollars ($25,000), the owner's liability to claimants for amounts properly paid to the prime contractor is limited to the amount by which the aggregate of claims exceeds twenty-five thousand dollars ($25,000).

Comment. Section 3244.5 limits the homeowner's liability to the extent of the home improvement payment bond. The effect is to spread the risk between the owner and potential mechanic's lien claimants, with claimants risking up to 50% of the $25,000 ceiling on the bond.

☞ **Staff Note.** Subdivision (b) is troublesome. It is difficult to envision how it will play out in all the possible circumstances where the contract is over $25,000. The assumption is that a breakdown will become apparent through missed payments to subcontractors or suppliers before the liabilities have surpassed $12,500, but that may be unrealistic, particularly on a larger project. For example, if work under a $100,000 contract has stopped because the subcontractors and suppliers have not been paid the $50,000 they are owed, and the owner has paid $50,000 to the prime contractor, the owner would still be liable for $25,000 "double payment" — $12,500 would come out of the bond and the claimants would take a $12,500 pro rata loss. If some claimants had been paid, then the loss would fall on those who had not.

The intent is that all other rules concerning bond conditions, notices, enforcement, and the like would apply to bonds under this article. Of course, all of those rules are also in need of review — a process the staff has only barely started. If the Commission decides to proceed with the payment bond approach, the staff will need to review the other procedures to see if any additional clarifications and exceptions are needed to make this article fit.

§ 3244.6 Waiver prohibited

3244.6. The payment bond under this article may not be waived. A contractual provision or other agreement purporting to waive the requirements of this article is void.

Comment. Section 3244.6 makes clear that the mandatory 50% payment bond under this article is not waivable.

☞ **Staff Note.** This section is included to flag the issue of waivability. We are not sure that parties should not be able to make some other arrangement. If the owner wants to use a joint control account, for example, involving a $150,000 remodeling job, it is just an added expense that serves no real purpose to also require the payment bond, which would overlap its protections to the extent of one-sixth of the contract price (or one twelfth, depending on how you look at it).

§ 3244.7. Operative date

3244.7. This article applies only to works of home improvement under contracts executed on or after January 1, ____.

Comment. Section 3244.7 gives this article prospective effect, depending on the date of the contract between the homeowner and the prime contractor. The date of any contract between a prime contractor and subcontractors and suppliers is not relevant to the operation of this article.
