Study H-820 December 6, 2000

# Memorandum 2000-78

## Mechanic's Liens: Reform Proposals

This memorandum continues our consideration of ways to deal with mechanic's lien problems involving home improvement contracts. In a series of meetings, the Commission has now considered a fairly wide variety of possible solutions. The next step will be to decide which avenues to pursue and which to abandon for the time being.

The following materials are attached:



### STUDY STATUS AND OVERVIEW

A brief review of the status and background of this study may be useful, particularly for interested persons who have just recently become aware of the Commission's study.

### Scope of Study

The Commission is considering reform of the mechanic's lien laws because of a request from the Assembly Judiciary Committee to undertake a "comprehensive review of this area of the law, making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions." (Letter from Assembly Members Sheila James Kuehl (Chair) and Rod Pacheco (Vice Chair), June 28, 1999.) The Commission has been focusing on mechanic's liens in the home improvement area because of the interest in this subject during the last legislative session, particularly involving Assembly Member Mike Honda's ACA 5, AB 742, and AB 2113. But the Commission also intends to conduct a thorough review of the mechanic's lien and stop notice statutes. A number of issues have been identified in Gordon Hunt's background reports and in correspondence from a variety of individuals since the study

began. Law review articles over the past 30 or 40 years have also discussed a number of problems with the law that have not been fully addressed. At this point, the final scope of the Commission's study has not been determined, but it is not limited to mechanic's liens arising out of home improvement contracts.

**Ideas Considered Thus Far**

In no particular order, here are most of the major proposals and options for reform of mechanic's lien law applicable to single-family, owner-occupied dwellings that the Commission has considered to date:

- **Full payment defense** — homeowners who paid the prime contractor in good faith under the terms of the contract would have a defense against enforcement of any mechanic's lien claim.
- **Privity requirement** — returning the law to the era before enactment of the "direct lien" in 1911, this proposal would grant lien rights only where there was a contractual relationship between the owner and the claimant.
- **Direct pay** — subcontractors and suppliers would not have lien rights unless they request payment directly from the owner; they would choose whether to rely on creditworthiness of their customer, or request direct payment. (Another version of a direct pay approach is discussed near the end of this memorandum.)
- **Lien recovery fund** — unpaid liens would be compensable from a fund administered by a state agency, financed by some type of assessment on contracts or contractors. CSLB reports that two states (Michigan and Utah) have this type of fund.
- **Homeowner protection fund** — homeowners who end up paying twice to satisfy mechanic's liens would be reimbursed from a fund created by an assessment on building permits. (This proposal has been prepared by Prof. Clark Kelso and the Institute for Legislative Practice, and will be included in a supplement to this memorandum.)
- **Mandatory 50% payment bond** — prime contractors would get payment bonds in the amount of 50% of the contract price for contracts not exceeding $25,000 (or some other appropriate level), which would substitute for the lien. This is an option under existing law.
- **Blanket payment bond** — home improvement contractors would provide a blanket bond of $50,000 or some other amount as an adjust to the license bond, to provide some protection against double payment by homeowners.

- **Retainage** — a percentage of the contract (e.g. 10% or 25%) would be held for 30 days to clear lien claims, with the option of bonding to accelerate final payment.
- **Joint control** — considered in more detail in this memorandum, contractors would be required to use escrow accounts to process payments and releases.
- **Check-writing service** — a simplified and cheaper alternative to joint control, a neutral party would match releases with payments.
- **Increased license bond** — increase the existing $7,500 license bond to a level that would provide more protection for homeowners.
- **Better notice and consumer education** — improve notices so homeowners understand their rights and options. The Contractors State License Board had been working on improving notice as part of its "HIPP 2000" initiative.

Proposals that replace an existing lien right with some other right or procedure generally would have the significant benefit of eliminating the blizzard of preliminary notices, and some proposals would address the uncertainty of the existing release procedures. Details of any proposal would be fleshed out once the Commission has narrowed its focus.

**Commission Conclusions and Recommendations**

At this point, the Commission is still considering new ideas and investigating in more detail approaches that were suggested in earlier materials. The Commission has not finally rejected any schemes that have been discussed, nor has it decided which approach (or approaches) should be pursued in preparing a tentative recommendation.

It is the Commission's usual practice to consider all reasonable ideas and then prepare a tentative recommendation, which is circulated widely for review and comment by interested persons. The Commission does not make a final recommendation to the Legislature until this process has been completed — a process that, on major issues, extends over a period of two or three years, or even longer.

## JOINT CONTROL

At the October meeting, the Commission asked for more information on joint control companies and how their services might be employed to provide useful protections in the home improvement contract arena.

**Existing Law and Practice**

The CSLB website information on "What You Should Know Before You Hire a Contractor: Bids and Funding (or Don't Get Nailed By An Unscrupulous Or Unlicensed Contractor)" explains the use of joint control companies as follows:

> Even if your lender does not require one, you may want to consider using a joint control company to disburse contract payments. A joint control company is a licensed escrow company that specializes in handling funds for construction jobs. Instead of giving the money to your contractor, you give it to the joint control company, which then makes payments to your contractor, subcontractors, or other companies that supplied labor or materials for your job. However, using a joint control company is no substitute for a payment bond.
>
> Caution: joint control companies are not required to inspect your job to see if it has been completed or the materials supplied. They generally provide vouchers for the borrower to complete and present to the joint control company as authorization to pay the contractor based on bills from the contractor. The borrower should be careful not to authorize payment to the contractor in advance of any work to be performed. The vouchers should be guarded as if they were checks used for paying bills and only signed and used as each phase of the project is completed.
>
> For additional protection, you should make certain that the joint control company you hire uses an "Addendum to Control Agreement Escrow Instructions". This addendum is in writing and must be signed by you, your contractor, and a representative of the joint control company. In the addendum the joint control company agrees to a method of making payments on your project best designed to protect your money and property. Under the terms of this addendum the company generally makes on-site inspections as its means of guaranteeing that any work or materials it pays for have been provided.
>
> In looking for a joint control company, check with your lender or your contractor for recommendations. For a small percentage of the contract price, a reputable joint control company will probably eliminate or reduce many of the financial problems that may arise on your construction project.
>
> If you want a completion bond or joint control company, or both, make sure you clearly state this in the contract. If you need further information regarding bonds, contact your attorney.

(See <http://www.cslb.ca.gov/beforehiring13.html>, visited Dec. 5, 2000; the "Addendum" and accompanying instructions from CSLB are set out in Exhibit pp. 14-16.)

CSLB does not regulate joint control companies. Joint control agents are governed by the Escrow Law, and like escrow agents, are licensed by the Department of Corporations. See, e.g., Fin. Code §§ 17000 (Escrow Law), 17005.1 ("joint control agent" defined), 17202 (license bond in amounts from $25,000 to $50,000, depending on annual business). A "joint control agent" is defined in Financial Code Section 17005.1:

> 17005.1. "Joint control agent" means a person engaging in the business of receiving money or other property for disbursal or use in payment of the cost of labor, materials, services, permits, fees, or other items of expense incurred in the construction of improvements upon real property. As used in this section, "in the business" means the conduct of the aforesaid transaction either for compensation or without compensation as a primary business or as an incidence to another business, but shall not mean the conduct of the business of real estate lending or of acting as an authorized representative, agent or loan correspondent for such a lender.

A new addition to the statues recognizes "Internet escrow agents," but it isn't completely clear whether joint control agents can be internet escrow agents. Section 17005.6 provides that "'escrow agent' … includes joint control agents and Internet escrow agents." In light of the purpose of the new statute, however, we assume that all escrow agents under the statute can act as Internet escrow agents. See 1999 Cal. Stat. ch. 441 (AB 583, Papan). For an example of an Internet escrow company, see <http://www.iescrow.com/>.

The Internet escrow legislation recognizes that escrows are being used for smaller amounts than traditional escrows. The Senate Floor Analysis (July 14, 1999) of AB 583 reports that the average Internet escrow transaction is about $500, compared to traditional transactions of about $100,000. This suggests that Internet escrows could be economical in the home improvement industry for smaller contracts than traditional joint control arrangements. This new form of escrow may also be more capable of responding to the demand that would be generated by mandatory joint control for home improvement contracts.

**Check-Writing Service**

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, Sam Abdulaziz earlier proposed a check-writing service, which would not involve verifying progress or examining release forms and other

protective chores. (See Memorandum 2000-37, p. 7.) Mr. Abdulaziz suggests that this could be done economically with computer technology and Internet access. The fewer the duties that are imposed on the joint control agent, the more a joint control scheme begins to resemble a check-writing service. The staff tends to think that a more protective level may be needed to address the double payment risk. If a new statutory procedure is to be imposed, it should have the effect of significantly reducing or eliminating the double payment problem, and the coordinate problem of subcontractors and suppliers not getting paid, or the expense and effort of imposing a new statutory scheme will not be justified. Unfortunately, the cost of the service goes up as the risk is transferred so that the cheaper alternative may be the optimum approach.

**The Joint Control Marketplace**

The problem with any of the proposals the Commission has considered that require a new participant in home improvement contracts is that the industry involved would have to respond effectively to make it work. The staff has had some concern about mandatory bonding because we do not know how or even if the surety companies have the resources to provide the services needed, leaving aside the cost issues. The same thing would be true for the joint control companies. We don't have any figures on the use of joint control accounts, particularly in the home improvement industry, but it is probably an insignificant number.

The existing system puts the burden on the homeowner to understand the system, learn the options, and decide which protection to use. We think it is generally agreed that most homeowners do not use the options of bonding or joint control, whether due to ignorance, laziness, overtrustfulness, or cost-aversion, and there does not appear to be a robust market of competing joint control companies. We don't find "joint control companies" listed in the yellow pages. A local title company office we called didn't have any idea what a joint control account was or whether they provided that service, and referred us to the head office, where we were told they didn't handle such things.

Gordon Hunt, a Commission consultant, reports that he spoke with two joint control company representatives. One does not accept residential business and the other works exclusively with banks. Mr. Hunt's conclusion is consistent with the staff's limited research: that there does not seem to be much of a market for joint control companies involving home improvement contracts.

An escrow company we called was familiar with joint control accounts, although they didn't list construction escrows in their yellow pages advertisement. This company charges $650, plus $2 for each $1,000 paid, and $15 per disbursement, but for that fee do not do any inspecting (contrary to the expectation of the CSLB, perhaps). This works out to a 14% charge on a $5,000 contract with three progress payments, and drops to 3.4% on a $25,000 contract with 10 payments, and reaches 1% on contracts of $100,000.

The fees of "i-Escrow, the Online Escrow Service," are comparable at some levels, but significantly lower for smaller amounts: if paid in cash, the fee is 2% for transactions between $100 and $25,000, and 1% for transactions over $25,000. (See <http://www.iescrow.com/finfaq.html#cost>, visited Dec. 6, 2000.)

What would happen if a statute mandated use of joint control accounts and the escrow industry can't handle the demand efficiently or imposes too great a cost? Perhaps it would be simpler and cheaper to mandate payment by joint checks and make joint checks an effective protection.

**Outline of Mandatory Joint Control for Home Improvement Contracts**

For discussion purposes, the staff suggests consideration of mandatory joint control with the following elements:

(1) *Home improvement contracts.* As with other proposals the Commission has recently considered, this joint control scheme would apply to "works of improvement" on single-family, owner-occupied dwellings (or some other formulation, such as "home improvement contract" as defined in Business and Professions Code Section 7151 in the Contractors' State License Law).

(2) *Mandatory*. The joint control would have to be mandatory, or very difficult to waive, if it is to have its intended effect of protecting consumers. If a job is bonded or 50% bonded, that would probably be a sufficient substitute remedy.

(3) *Threshold*. Contracts below a certain amount should not be subject to the joint control requirement because the protection is too costly in light of the risk. We don't know the right amount, but something like $5,000 or even $10,000 seems appropriate.

(4) *Prime contractor responsibility*. The prime contractor would be required to set up the joint control with a licensed joint control agent and inform subcontractors and suppliers dealing directly with the prime contractor of the joint control account. The prime contractor would also inform the control of all parties contracting with the prime.

(5) *Subcontractor and supplier responsibility*. Parties in privity with the prime contractor will need to make sure that there is a joint control account in place. A mechanism would need to be set up so that subsubcontractors and suppliers furnishing to subcontractors get information on the joint control account, since they will submit claims to the control.

(6) *Homeowner responsibility*. Unlike the existing system where the burden is placed on the homeowner to learn the law and the options, select an appropriate strategy, and implement it, the suggested mandatory joint control system relieves much of the burden on homeowners. Payments would need to be made in a timely fashion to the joint control agent, but no other special action would be needed unless the homeowner wanted to use some other approved substitute remedy such as a bond.

(7) *Effect on mechanic's lien rights*. It would not be necessary to affect the operation of the existing mechanic's lien statute for a joint control scheme to work. If the money is funneling through the joint control agent, then those wishing to be paid would know where to go first. Unfortunately, this does nothing to cure the problem of too much paper shuffling. If the Commission decides to pursue the joint control option, the staff would like to work on ways to eliminate the need to give preliminary notices when a proper joint control arrangement is in effect and the owner is making appropriate payments.

(8) *Enforcement*. The duties of licensed contractors would be enforceable by CSLB, and joint control companies are subject to the authority of the Commissioner of Corporations. But the major enforcement mechanism would be parties wising to be paid expeditiously being sure the joint control was in effect and owners wishing to avoid mechanics liens making sure payments are properly made.

## ADDITIONAL ISSUES

The letters included in the Exhibit address other issues. James Acret suggests general reform of the content and effect of the release form; Adam Streltzer provides commentary about "direct pay" proposals from his experience with subcontractors and suppliers; Ellen Gallagher outlines a new combination of bonding and direct pay. We discuss these matters briefly below.

### Release Notice

James Acret, a Commission consultant, proposes to address the misleading nature of releases. (See Exhibit pp. 1-2.) This is a general problem under the

mechanic's lien law, but is most acute with inexperienced or naive owners, which is the likely condition of a homeowner. Mr. Acret points out that releases are not effective unless the claimant has actually been paid, even though an owner may naturally believe otherwise. He concludes:

> It is beyond argument that the statute should allow potential claimants to effectively release their claims. Project owners should be able to protect themselves against becoming responsible for the debts of their contractors and subcontractors. The present wording is unfair to project owners who are led to believe, naturally enough, that the forms of release specified by the legislature are effective. The existing system is subject to abuse because a claimant can sign a mechanics lien release, induce the owner to part with its money, and then record a valid mechanics lien claim.
>
> Reform would be accomplished by redrafting the release forms in simple and effective language.

The staff believes this is a good proposal and intends to address Mr. Acret's concerns when we next take up revision of the general mechanic's lien statute, since this issue is not limited to home improvement contracts.

**Lien Bond Between Contractor and Subcontractors-Suppliers**

Ellen Gallagher, staff counsel with the Contractors State License Board, has provided a "new twist" on the direct pay concept. (See Exhibit pp. 9-13.) Ms. Gallagher gives a useful and concise summary of the fundamental problem we have been considering thus far in this study and reviews the various approaches the Commission has been considering. (We will not resummarize the material here, and recommend that you read her letter in detail.) She concludes that the sensible approach is to shift the risk of a contractor not paying from the homeowner to the subcontractors and suppliers and give them the tools to protect themselves. (*Id.* at 10.) She proposes creating a "line of credit" form of bond to protect payment to the subs and suppliers if the prime contractor is paid but fails to pay subs and suppliers. This type of bond should be very inexpensive because of its limited nature and small risk to the surety. (The proposal is set out in more detail in Exhibit pp. 11-13.)

This "lien bond" would not be mandatory, because there is concern about driving worthy but unbondable contractors out of the market or underground. It is coupled with a direct pay feature, giving the subcontractor and suppliers a way out where the contractor can't get the bond and they are not willing to

extend credit. Lien rights would continue until the homeowner pays and 20-day preliminary notices would not be necessary.

The staff is still analyzing this proposal. We think it answers concerns about the direct pay proposal considered at an earlier meeting, while preserving the benefit of eliminating needless and confusing notices. We plan to discuss the outline at the meeting so see if there are any undiscovered, fatal defects.

**Concerns with Direct Pay Proposals**

Adam Streltzer, an attorney from Los Angeles who works with small subcontractors and suppliers, has written concerning direct pay proposal. The gist of his concern is that the smaller subcontractors would be at a significant disadvantage and would not dare to ask for direct pay from the owner. See, e.g., Exhibit p. 4. Mr. Streltzer states that there is some discrimination against subcontractors and suppliers who attempt to use constitutional remedies under existing law. He believes a "blacklist" would develop and those electing the direct pay route would be driven out of business. *Id.* at 5.

Mr. Streltzer believes that reform of the mechanic's lien law is needed, but suggests further work on the recover fund and mandatory bond proposals. *Id.* at 7. He also suggests a provision for recovery of attorney's fees in mechanic's lien enforcement.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

Exhibit

# A PROPOSAL FOR MECHANICS LIEN RELEASE REFORM

James Acret, Commission Consultant

☞ **Staff Note.** The following material has been reformatted from electronic copy emailed to the Commission.

The statutory forms for releasing mechanics liens are broken and need fixing.

As the commission knows, the mechanics lien system subjects a property owner to the risk of having to pay debts incurred by the prime contractor and subcontractors even though the owner may have paid to the prime contractor the full agreed contract price. The commission has considered recommendations to exempt homeowners from this risk. If such legislation is adopted property owners other than homeowners will still be subject to the risk of double payment, and need an effective way to protect their property from unjustified liens.

The California mechanics lien system is designed to enable property owners to protect themselves from mechanics lien claims by identifying potential claimants, monitoring the activities of those potential claimants, ensuring that they are paid, and then obtaining releases from them. Under the system, potential mechanics lien claimants must give a preliminary notice to the owner by certified mail. The preliminary notice warns the owner of the double payment problem and suggests that the owner should protect itself by obtaining a release from the notice giver. The statute goes so far as to specify the release forms to be used and provides that the lien rights of a claimant cannot be impaired by any document other than the specified forms.

The statute authorizes four different release forms. Two are designed to apply to final payments and two apply to progress payments. (Progress payments are payments made by the owner to the prime contractor, usually monthly, during the progress of the work. The final payment is the last payment made to the contractor after the completion of the work.) An owner may "protect" itself by

obtaining mechanics lien releases from all persons who have given preliminary notices.

The structure of this system naturally leads owners to believe that the statutory releases are enforceable. The problem is that in any case in which the claimant has not been paid the releases are not enforceable. Legalistic wording provides that the releases are only effective if the party signing the release has been paid. Since only unpaid claimants have the right, or indeed any reason, to assert a mechanics lien claim, the ironic fact is that the form specified by the statute excludes the entire universe of potential mechanics lien claims.

The unconditional release form contains a warning in bold face type "YOU" are giving up mechanics lien rights "EVEN THOUGH YOU HAVE NOT BEEN PAID." This same form also specifies that it does not apply to work or materials that have not been paid for!

It is beyond argument that the statute should allow potential claimants to effectively release their claims. Project owners should be able to protect themselves against becoming responsible for the debts of their contractors and subcontractors. The present wording is unfair to project owners who are led to believe, naturally enough, that the forms of release specified by the legislature are effective. The existing system is subject to abuse because a claimant can sign a mechanics lien release, induce the owner to part with its money, and then record a valid mechanics lien claim.

Reform would be accomplished by redrafting the release forms in simple and effective language.

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**Re: Current Proposals Pending Before the California Law Revision Commission Regarding Changes to the Mechanic's Lien Law**

Dear Mr. Ulrich:

Thank you for taking my telephone call last week. Per our discussion, this letter is to memorialize some of the elements of our discussion, and to provide your office and the California Law Revision Commission ("Commission") with written comments regarding the pending changes to the Mechanic's Lien Laws.

Since leaving earlier this year the offices of Cantor & Weinshenk, P.C., a business litigation and construction law boutique firm in Encino, California, I have represented various small subcontractors, material suppliers and manufacturers in an assortment of litigation and transactional issues, including collections, mechanic's liens, stop notice, and surety bond matters.

An overwhelming majority of my clients support the efforts to modernize and improve the current Mechanic's Lien laws. However, after my discussions with both you and Mike Honda, it does not appear that my clients' concerns have been raised by any of the relevant trade groups. For background purposes, as smaller subcontractors, suppliers, and manufacturers, my clients sometimes avoid the mechanic's lien and/or stop notice remedies ("the lien remedy") because they perceive it does not efficiently nor economically result in full payment. However, my clients appreciate the security of knowing they have the lien remedy available on every job they undertake, unless they affirmatively chose to forego its benefits by, for instance, not providing Preliminary Notice, or waiving the lien remedy after the work is finished.

My clients wish to see their concerns resolved in a modernized Mechanic's Lien law which would balance the interests of landowners with an effective, efficient, and economical set of remedies for subcontractors and material suppliers. However, my clients are gravely worried about the current proposals pending before the Commission. This letter addresses the most troubling proposed revision, informally referred to as the "Direct Pay" proposal.

**Discussion of the "Direct Pay" Proposal**

In essence, the "Direct Pay" proposal would modify the current mechanic's lien law to permit subcontractors and suppliers to request payment directly from the land owner. Failure for an otherwise eligible subcontractor or supplier to request direct payment would result in the waiver of the subcontractor's or supplier's rights under the Mechanic's Lien law. The only written expression of the "Direct Pay" proposal appears to be that suggested by Mr. James Acret, reprinted in your October 2, 2000 First Supplement to Memorandum 2000-63, as follows:

> "No claimant shall have mechanic's lien or stop notice rights against a single-family home occupied or to be occupied by its owner unless the claimant has a direct contractual relationship with the owner."

Although the genesis of this proposal is to protect homeowners from the "double payment" problem. Typically, "double payment" becomes a problem when an owner has paid a contractor in-full to complete a work of improvement or renovation, but mechanic's liens are thereafter recorded against the homeowner's property due to the failure of the contractor to pay its' subcontractors or suppliers.

**Problem: "Direct Pay" Will Produce Blacklists and Discrimination**

The generic concept incorporated in the "Direct Pay" proposal is troubling. My clients' primary concern is that adoption of the "Direct Pay" proposal will lead to unfair and improper discrimination against smaller subcontractors, suppliers and manufacturers who elect "direct payment" from the owner and thereby retain their lien remedy (their mechanic's lien and/or stop notice rights). My clients predict that many prime or general contractors would avoid using their products or services, and instead chose only those subcontractors and suppliers who would agree to waive their lien remedy by not making the new "direct payment" election.

This concern is not overstated. Due to their size and lack of resources, many smaller subcontractors already have problems remaining competitive with their larger rivals. The lien remedy is essential to enforcing their payment obligations. However, some prime or general contractors are reluctant to employ subcontractors whom have a history of resorting to the lien remedy to resolve payment and/or other forms of construction contract disputes. This is especially true for smaller entities involved in projects on either of the "far ends" of the construction project spectrum, i.e., the construction of large, national chain stores, and construction involving single family residences. Thus, on some occasions, subtle discrimination occurs even under the current Mechanic's Lien law against those subcontractors and suppliers who attempt to retain constitutional remedies.

The adoption of the "Direct Pay" proposal would, in practice, create a "blacklist" of contractors and suppliers who are avoided by contractors specializing in construction projects involving single family residences. In addition, my clients believe that such contractors would find a competitive advantage in advertising or marketing the fact that they do not use or employ "Direct Pay" subcontractors and suppliers. In the end, those who elect "Direct Pay" would be effectively excluded from the marketplace. My clients feel they would have absolutely no choice but to not select "Direct Pay" and thereby waive their mechanic's lien and/or stop notice rights prior to entering any job, or else they might not remain in business. This is a poor result, and is contrary to the constitutional basis for the Mechanic's Lien law.

**Problem: The "Direct Pay" Proposal Does Not Truly Resolve the "Double Payment" Problem**

Furthermore, the "Direct Pay" concept does not truly resolve the "double payment" problem, but instead shifts the burden of such payment disputes from the homeowner to the subcontractor and/or supplier. In practice, "Direct Pay" will protect homeowners merely because it purges from the marketplace those subcontractors and/or suppliers who chose to retain the possibility of asserting a mechanic's lien. Unfortunately, this result obviates the primary purpose for the Mechanic's Lien law—to provide a method to secure payment to those whose work actually created and/or whose supplies were incorporated into the very property to which the lien attaches.

**Problem: The Proposed Benefits of Adopting the "Direct Pay" Proposal Would Be Illusory**

Additionally, the language of the "Direct Pay" proposal is itself troubling. What is the meaning of the proposed phrase "direct contractual relationship with the owner?" A "contract" is a an agreement between two (2) or more parties creating obligations that are enforceable or otherwise recognizable at law. Black's Law Dictionary, p. 318 (7th ed. 1999). See, Cal. Civ. Code § 1549. Pursuant to California law, a "contract" requires parties capable of contracting, consent to the promises made in the agreement, a lawful purpose, and consideration. Cal. Civ. Code § 1550. Contracts may be either "express" or "implied." See, Cal. Civ. Code § 1619; Cal. Comm. Code § 2204 (U.C.C. § 2-204). An "express" contract is one in which the terms are stated in words, either orally or in writing. Cal. Civ. Code § 1620 (definition). See, Cal. Civ. Code § 1622 (express oral contracts are valid to the extent there is not some other statute requiring the agreement to be in writing). An "implied" contract is one in which the terms are manifested by something other than words, such as conduct. Cal. Civ. Code § 1620 (definition). There does not appear to be an express statutory definition of "direct contractual relationship."

There is, however, a meaningful concept in the current Mechanic's Lien law for the term "direct contract," which is a phrase very similar to the language contained in the proposed "Direct Pay" proposal. In simple terms, except for those under "direct contract" with the landowner or performing actual labor for wages, all prospective lien or stop notice claimants must give "Preliminary Notice" to the landowner, contractor, and to the construction lender, if any, in order to be eligible for the lien remedy. See, Cal. Civ. Code § 3097. C.f., Cal. Civ. Code § 3098 (similar requirements for public works stop notices). Further, if there is a construction loan, even prospective claimants under "direct contract" with the landowner are required to give the "Preliminary Notice." See, Cal. Civ. Code § 3097(b). The form, format, and information required for such Preliminary Notice is set forth in the statutes. See, Cal. Civ. Code §§ 3097, 3097.1, & 3098. Note that compliance with the Preliminary Notice requirements is mandatory to determine a claimant's eligibility to use the remedies under the Mechanic's Lien law in order to comport with constitutional notions of due process, which ordinarily requires notice prior to the taking of private property.

The law defining "direct contract" within the meaning of the Preliminary Notice statutes (Cal. Civ. Code sections 3097 & 3098) is well-established. For instance, subcontractors are usually hired by a prime or general contractor without any involvement by a landowner or homeowner. Material suppliers are also traditionally selected by the contractors without involvement by the landowner. In such case, the conclusion is obvious that the "contractual relationship" is between the contractor, on the one hand, and the subcontractor and/or supplier, on the other hand. Such a relationship is not a "direct contract" within the meaning of the Preliminary Notice statutes. See, Cal. Civ. Code §§ 3097 & 3098, discussed supra. A "direct contract" exists for these purposes only where the owner is a party to the agreement, as compared to an agreement between a contractor and someone else such as a lessee. See, e.g., Kim v. JF Enterprises (1996) 42 Cal.App.4th 849.

It is likely that the "direct contractual relationship" language of the "Direct Pay" proposal incorporates the same definition as that of the phrase "direct contract" under the Preliminary Notice statutes because the language is very similar, and because both apparently trigger or determine eligibility for the lien remedy. In light of this similarity of language and purpose, would adopting the "Direct Pay" proposal provide homeowners any effective benefits?

To answer this question, we need to inquire about the subcontractor or supplier who is not in a "direct contract" within the meaning of the Preliminary Notice statutes. What happens when a landowner or homeowner is served with Preliminary Notice by such a subcontractor or supplier, and the land owner fails to properly object to the same? Currently, this results in the subcontractor and/or supplier being deemed to be in "direct contract" with the homeowner within the meaning of the Preliminary Notice statutes. See, e.g., M. Arthur Gensler, Jr., & Associates, Inc. v.

Larry Barrett, Inc. (1972) 7 Cal.3d 695, 707; Benson Elec. Co. v. Hale Bros. Assoc., Inc. (1966) 246 Cal.App.2d 686, 693. Therefore, presumably, if the "Direct Pay" proposal was adopted, then any subcontractor or supplier could avoid its application and thereby retain their lien remedy (mechanic's lien and stop notice rights) even without electing the new "direct payment" option merely by properly serving Preliminary Notice without objection. By doing so the contractor or supplier is deemed to be in "direct contract" with the homeowner, and therefore in a "direct contractual relationship" with the homeowner as required for exclusion from the "Direct Pay" proposal. There is no need to comply with the "Direct Pay" procedures. Therefore, adopting the "Direct Pay" proposal would have no effect.

As analyzed, the language of the "Direct Pay" proposal is slightly uncertain. Even though the proposed language is susceptible to an interpretation removing this uncertainty, this leads to the conclusion that the benefits to be gained by homeowners through its adoption as law would be illusory and ineffective.

**Other Comments**

Additionally, my clients agree with the concerns raised by Gordon Hunt in his August 17, 2000 report to the Commission that the "Direct Pay" proposal unfairly places homeowners into disputes between contractors and subcontractors.

**Assessment of the "Direct Pay" Proposal**

My clients, as well as many other smaller subcontractors, suppliers, and manufacturers, appreciate the efforts to modernize and revise the Mechanic's Lien law. We especially applaud the work of Mr. Gordon Hunt, as Consultant, and also Mr. James Acret, for their hard work and exciting ideas. However, the "Direct Pay" proposal is not an acceptable revision, and we strongly urge the Commission not to adopt such a proposal in its final report to the California Legislature and the Judiciary Commission.

**Other Proposals Pending Before the Commission**

Please also give further consideration and analysis to the other proposals pending before the Commission. Hopefully after further commentary and analysis there will be something suitable for recommendation to the Legislature. In particular, the "Recovery Fund" and "Mandatory Bonding" proposals are both very exciting, as they present incentives for the smaller subcontractors and suppliers, such as my clients, to participate in the Preliminary Notice and mechanic's lien process, in that payment may be authorized faster and would be more effective and efficient, possibly including the recovery of attorneys' fees.

Note that in regard to the "Full Payment Defense," this proposal clearly conflicts with the constitutional basis for the Mechanic's Lien law, and would need substantial modification before I could present to the Commission any meaningful comments emanating from my clients' perspective.

**Conclusion**

Thank you very much for taking the time to speak with me and to consider these comments. I hope they are suitable for distribution to all parties in interest, and I request your efforts to submit these comments to the Commission members. Please feel free to contact me at anytime if you have any questions, comments, or concerns.

Yours very truly,

ADAM L. STRELTZER, ATTORNEY-AT-LAW

By: 
ADAM L. STRELTZER

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CONTRACTORS STATE LICENSE BOARD
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December 4, 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: Modified Direct Pay

Here is a rough sketch of the proposal you and I have been talking about. It is a new twist on Direct Pay.

**Why do we need a new approach?**

Present mechanics' lien law places responsibility for avoiding liens on the property owner. A lien makes sense if a property owner fails to pay. The owner has been unjustly enriched by the contributions of another. The complication arises when the property owner pays but the contractor fails to pass on that payment to subcontractors and suppliers.

Continuing to make the property owner responsible may be sensible in commercial construction where the property owner is expected to understand liens, bonds, payment strategies and the like. Right now, the law makes the property owner responsible for making sure the non-contractor contributors are responsible for making sure every one is paid. The present approach, however, is not sensible for homeowners.

**What's the matter?**

Homeowners have no reason to know about liens. Homeowners will hire contractors for big projects only once or twice in their lifetime. Yet, under the present scheme, they have complete responsibility for making sure all contributors are paid. They are supposed to find out about this responsibility by reading a notice provided by the contractor. This notice, the Notice to Owner, is nearly inexplicable. It is dense and complicated, covering information usually taught in a 2-3 hour lien class. More important, the idea of lien risk is conceptually convoluted; homeowners simply can't

understand that how they should have to pay twice.

The Notice describes a few strategies for lien protection. None are very useful. The preferred strategy – a series of conditional and unconditional releases – is only helpful to very sophisticated homeowners who have the foresight to withhold a percentage of the payments. Only one recommended strategy is easily understood and available – the joint check. But new case law indicates that even this strategy is suspect. To top it off, contractors often fail to provide the notice – a good way to avoid homeowner suspicion.

Further complicating matters, the 20- day Preliminary Notice, the notice from the subs and suppliers that informs the homeowner that lien rights are at issue, can be sent *after* the homeowner has paid and still be valid. This lien prevention process may be sensible for commercial transactions; it does not work for homeowners.

**What's been done about changing the process?**

Over the past year, the Commission has examined a number of mechanics' lien proposals, including increasing consumer awareness through revised notices, the Direct Pay plan, payment and performance bonds, and a full payment defense. Despite diligent review, it does not appear that any of these will work.

Rewriting the Notice to Owner made the notice slightly more readable but the revised notice still did not provide enough information to be useful. The new notice also didn't cover the situation where the contractor fails to provide the notice.

Direct Pay was said to involve too much work for homeowners.

Payment and performance bonds would only be available to contractors with sufficient assets to make the bond unnecessary not to need the bond.

The full payment defense simply cut off the lien rights of subs and suppliers with no recourse. The full payment defense also created significant constitutional issues.

Over the last few months, I worked on a contract form that would include all the information required by law, including lien notices, explanations of progress payments, and the like. This did not work either. As long as we rely on the contractor to provide information the contractor does not want the consumer to have, these strategies won't work.

The only sensible approach is to shift the risk of a contractor not paying to the subs and suppliers and provide them with ways to make sure they are paid.

**New Bond**

Let me describe a new bond proposal. A few bond companies are interested in the concept, called it "novel" and "intriguing", but I haven't gotten a definitive answer yet. I hope to know by your December meeting.

Instead of creating bonds that protect homeowners, let's create a bond that protects subcontractors and suppliers. This bond would work like a line of credit. The contractor would get a bond for $X,000, *payable only if the contractor is paid by the homeowner but fails to pay the sub or supplier.*

**Here's how it would work:**

The contractor would register subs and suppliers with the bond company. For example, the contractor doing a couple of bathroom remodels might get a $25,000 bond. The contractor would register the tile subcontractor for 5 different jobs of $3,000 each, as well as register 5 orders of $1,000 each for the material suppliers. Total amount covered: $20,000. Amount left: $5,000.

Unlike payment and performance bonds, these bonds should be very inexpensive since they cover only the transaction between the contractor and the sub or supplier.

Last year, in the Direct Pay Proposal, I described the reasons contractors fail to pay. Let me reiterate these points in terms of the new bond.

There are a number of reasons for liens:

The homeowner may not have paid the contractor. Under this situation, the bond would not be implicated. The subcontractor or material supplier can 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. Under the home improvement contract strategy of paying only for performance, contractors should not request payment from the homeowner until the work is satisfactorily completed. If the contractor jumps the gun, the dispute is where it belongs: between the subs/suppliers and the contractor.

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. Under the bond scheme, these issues are resolved by industry.

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 or material supplier 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.

The bond scheme will keep contractors in check. The limit keeps the contractor from getting too far ahead. To continue to buy supplies and hire subs, the contractor must keep payments up to date.

**Here's how a lien bond would work in a modified direct pay plan:**

The homeowner would check out and select a contractor. The homeowner would be responsible for making sure the contractor can do the project. How? By checking with the CSLB, by looking at past projects and by checking the contractor's references.

Once hired, the contractor would be responsible for selecting the subs and suppliers. Prior to providing material or working on a project, the suppliers and subs would have to evaluate the contractor. Does this contractor have a good track record of paying?

Contractor has good credit and good track record for paying

If the contractor pays for work and supplies as soon as progress payments are made, the sub or supplier should feel comfortable "fronting" the services or supplies. Under this plan, the subs and suppliers do not have to file preliminary notices on the chance the homeowner will not pay. Lien rights continue until the work is completed and homeowner pays the contractor.

Contractor slow to pay or has inadequate assets

If the subs and suppliers evaluate the contractor and find the contractor has a history of slow payment or credit problems, they could require the contractor to register the amount of work and/or supplies against the new lien bond. The limits on the availability of bonding would create a check on contractors in trouble.

Contractor very risky

If a contractor is too risky and can't afford a lien bond, the subs and suppliers

could opt for direct pay by sending a direct pay notice to the homeowner. Note: given the timing problems with the 20-day notice, the direct notice would have to come before the homeowner pays. Thus, subs and suppliers would help control the contractor with poor credit and no bond. This proposal would end the terrible problems created when homeowners pay before the 20- day Preliminary Notice. This would be true consumer protection.

Instead of relying on a complicated Notice to Owner to inform homeowners about risk and prevention, the direct pay notice would inform the homeowner of the risk and provide a fail-safe means of avoiding the lien. A big plus here is that lien transaction costs would be minimized; only homeowners at risk of liens would need to be notified.

Additional Benefits

Under this plan, there would be no Notices to Owner and no Preliminary Notices unless the sub or supplier opts for direct pay. Lien rights would always exist until the homeowner pays. Subs and suppliers could intervene at any time before the homeowner pays. If a surety gets worried about a contractor, the surety could even intervene any time before the homeowner pays the contractor.

Better yet, the thousands of subs and suppliers who presently lose their lien rights because they fail to provide a timely Preliminary Notice will not lose their lien rights. Their rights continue until the homeowner pays.

Finally, since contractors often want to conceal the actual costs of material and subcontracted work, under this plan, contractors will have a great incentive to keep their credit current. This should cut down on the possibility of losses from bankruptcy as well as the number of bankruptcies.

**Is it constitutional?**

Yes. The plan merely replaces and modifies the timing of the Preliminary Notice. Instead of sending a 20 day Preliminary Notice that can assert lien rights up to 20 days after work has started or supplies delivered, the Direct Pay can be sent any time before the homeowner pays.

I realize this is a very rough sketch but I wanted to keep us on track with solutions that do not require more effort and education for homeowners. Thank you for the opportunity to participate in this process. If you have any questions or want to talk, please call me at 916-255-4116 or e-mail me at EGallagher@dca.cslb.ca.gov.

Sincerely yours,

Ellen Gallagher, Staff Counsel
Contractors State License Board

# REGISTRAR-APPROVED JOINT CONTROL AGREEMENTS

Section 7159 of the Business and Professions Code provides for the use of a joint control approved by the Registrar of Contractors "covering full performance and completion of the contract" as an alternative to certain contract requirements. When a joint control is used, no schedule of payments is required in the contract.

A joint control is a builder's construction control service which acts as an escrow holder of a consumer's money. A joint control company manages the disbursement of funds to prevent you, the contractor, from being paid more than the value of the work already completed. A joint control also safeguards the consumer's property from mechanics' liens by requiring you, the contractor, to supply lien releases as progress payments are made to you.

A joint control normally includes an analysis of the contract and building plans or specifications, breakdowns of cost, and the preparation of an account from which the funds will be disbursed on regularly scheduled progress payments. An addendum (see below) must be incorporated into joint control agreements for any joint control company to be considered approved by the Registrar of Contractors.

The CSLB does not license joint control companies, nor does CSLB have any legal jurisdiction over joint control company activities. The criteria for "Registrar approval" was developed through mutual agreement of the CSLB and joint control company representatives. The resulting addendum (which follows), if included in the control agreement and followed, should prove to be beneficial to both contractors and consumers.

The CSLB does not maintain lists of approved joint control companies nor monitor their activities. Registrar approval is implicit if the addendum is used. Responsibility for incorporating the addendum in agreements, will rest solely with the joint control companies. Contractors and consumers should compare any joint control agreement with the following addendum to ensure that the control supplies the services required for approval.

# JOINT CONTROL ADDENDUM

## Addendum to Control Agreement/Escrow Instructions

This addendum is hereby incorporated into and becomes a part of the Control Agreement attached hereto dated _____.

1. Should any of the terms or provisions of the contract between Owner and Contractor or of the contract into which this Addendum is incorporated conflict with any of the terms or provisions of this Addendum, then the terms of this Addendum shall prevail.
2. Control agrees to control and disburse funds in the following manner:
   a) Supplier or sub-contractor submits to contractor duplicate copies of invoices requesting payment.
   b) If payment is justified, based on work completed, control accepts disbursement order or voucher in favor of payee for net amount.
   c) After signing by the contractor and the payee concerned, order for payment together with copies of invoices, unconditional lien releases and/or other substantiating data is delivered or mailed to the Control for payment.
3. Prior to issuing payment, Control agrees to verify:
   a) That all vouchers have authorized signatures.
   b) That adequate unconditional lien releases have been submitted in writing.
   c) That sufficient funds are on hand to pay the specific invoice(s) submitted.
4. Prior to issuing final payment, Control agrees to verify that project has passed final inspection by local building authorities, unless the scope of the contracted project does not require a final inspection.
5. After verification of the above, checks shall be made out payable to the supplier or subcontractor, or to the prime contractor and supplier or subcontractor, jointly.
6. Control agrees that in no event shall it disburse payments in excess of 100 percent of the value of the work performed on the project at any time, excluding finance charges.
7. The funds from this account shall be used only for the project described in the contract. Control warrants that work and material paid for by Control has been provided.

8. If this agreement is terminated for any reason prior to disbursement of all monies payable under the contract between Owner and Contractor, all subsequent disbursements to Contractor shall conform to the requirements of Section 7159 of the Business and Professions Code.

**NOTE:** Section 7159 of the Business and Professions Code requires that all change orders be in writing and signed by all parties.

SO AGREED this _____ day of _____, 19____.

_____

CONTROL

_____

CONTRACTOR

_____

OWNER

_____

OWNER

Contractors who furnish a joint control as part of the terms of a home improvement contract should be aware that the law prohibits them from having any financial or other interest in the joint control company. Also, it is the contractor's responsibility to determine whether or not the above addendum is included in the control agreement.

If an approved joint control or bond covering the complete contract is not furnished with a home improvement contract, the contractor may not require a down payment in excess of $1,000 or 10 percent of the total contract price, whichever is less. The contract must also contain a schedule of payments stated in dollars and cents and specifically referenced to the work or services to be performed or the materials and equipment to be supplied. Also, no payments other than the down payment can be in excess of the value of the work (excluding finance charges) performed at any time on the project.

**NOTE:** The last paragraph in the joint control addendum pertains to home improvement contracts other than swimming pool contracts. On all swimming pool contracts the downpayment cannot exceed $200 or 2 percent of the total contract price. The conditions relative to the downpayment for swimming pools and other home improvement contracts must be met if a joint control is not used.